IMF Country Report No. 24/56

DEMOCRATIC REPUBLIC OF TIMOR-LESTE

February 2024

2023 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE DEMOCRATIC REPUBLIC OF TIMOR-LESTE

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2023 Article IV consultation with the Democratic Republic of Timor-Leste, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its February 21, 2024 consideration of the staff report that concluded the Article IV consultation with the Democratic Republic of Timor-Leste.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 21, 2024, following discussions that ended on November 27, 2023, with the officials of the Democratic Republic of Timor-Leste on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 2, 2024.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- A **Statement by the Executive Director** for the Democratic Republic of Timor-Leste.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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PRESS RELEASE

PR24/59

IMF Executive Board Concludes 2023 Article IV Consultation with Timor-Leste

FOR IMMEDIATE RELEASE

Washington, DC – **February 27, 2024:** The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Timor-Leste.

Non-oil real GDP growth reached 4 percent in 2022, driven by the post-pandemic re-opening and a strong fiscal expansion. Growth is estimated to have slowed to 1½ percent in 2023 as difficulties in executing the budget surrounding the elections last May restrained public spending. Inflation surged to above 8 percent in 2023 driven by food prices and transport costs, but fell to 4.3 percent (y/y) in January 2024.

Growth is expected to recover to 3½ percent in 2024, supported by the government's prioritization of public capital expenditure. Inflation is expected to moderate further to 2½ percent by the end of this year given projected easing of global commodity prices. Growth is expected to remain around the pre-pandemic average of 3 percent in the long term, but policy actions could accelerate it.

Risks to the outlook are tilted to the downside. Near-term downside risks to growth include an abrupt onset of a global recession and heightened commodity price volatility. These could require a fiscal response, posing obstacles to expenditure restraint and adversely affecting the balance of the Petroleum Fund. Achieving the political commitment to rationalize public expenditure would reduce uncertainty surrounding the medium-term outlook. Developing the Greater Sunrise oil field presents a large upside risk in the medium term.

Executive Board Assessment[2]

Executive Directors noted that the near-term outlook has improved, with growth recovering and inflation easing in 2024. Despite impressive progress since independence in 2002, Timor-Leste remains a fragile post-conflict state. Modest growth is expected over the medium term, however, risks to the outlook are tilted to the downside. Directors emphasized the need to ensure fiscal sustainability and support higher growth and development, while diversifying the economy.

Directors called for gradual fiscal consolidation to avoid a depletion of the Petroleum Fund and secure fiscal sustainability. They welcomed the prioritization of capital expenditure in the 2024 budget and highlighted that further improving the quality of expenditure would support higher growth and protect the vulnerable. Directors recommended gradual revenue mobilization and

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.IMF.org/external/np/sec/misc/qualifiers.htm.

welcomed the authorities' commitment to introduce a VAT. This should be complemented by measures to strengthen tax administration. Directors also encouraged the adoption of a fiscal responsibility law and the formulation of a medium-term fiscal framework to put fiscal policy on a more sustainable path and help address external imbalances.

Directors noted that systemic risks to the financial system are low, and that banking sector capital and liquidity levels remain sound. They encouraged the authorities to promote financial deepening and inclusion by removing structural impediments to lending and developing digital financial services. Advancing the adoption of IFRS 9 and Basel III regulatory principles and addressing AML/CFT deficiencies are important measures.

Directors emphasized the need for structural reforms to promote private sector development, diversify the economy, and support sustainable growth. Measures to address bottlenecks in the agriculture and tourism sectors and to foster digitalization would help to boost growth. Directors encouraged the authorities to continue ongoing efforts to strengthen governance and the rule of law. Prioritizing human capital development, including by improving education quality and strengthening vocational education and training would help Timor-Leste to unlock its large demographic dividend. Noting Timor-Leste's vulnerability to climate change and natural disasters, Directors encouraged investment in climate-resilient infrastructure.

Directors welcomed ongoing capacity development projects and concurred that continued engagement with the Fund, in the context of the Country Engagement Strategy, would help to address the root causes of fragility. They also underscored the importance of enhancing coordination across development partners.

Table 1. Timor-Leste: Selected Economic and Financial Indicators, 2022-25

Non-oil GDP at current prices (2022): US$1.672 billion
Population (2022): 1.332 million
Non-oil GDP per capita (2022): US$1,256
Quota: SDR 25.6 million

	2022	2023	2024	2025
		Est.	Proj.	Proj.
Real sector				
Real Non-oil GDP	4.0	1.5	3.5	3.2
CPI (annual average)	7.0	8.4	3.5	2.2
CPI (end-period)	6.9	8.7	2.5	2.0
Central government operations				
Revenue	57.3	49.1	45.8	42.0
Domestic revenue	10.3	10.0	10.0	10.1
Estimated Sustainable Income (ESI)	35.7	28.6	26.4	23.5
Grants	11.4	10.5	9.4	8.4
Expenditure	115.5	90.5	88.3	85.1
Recurrent	92.0	67.9	65.0	62.6
Net acquisition of nonfinancial assets	12.1	12.1	14.0	14.1
Donor project	11.4	10.5	9.4	8.4
Net lending/borrowing	-58.2	-41.4	-42.6	-43.1
Money and credit				
Deposits	8.6	9.4	8.2	7.3
Credit to the private sector	34.5	19.2	7.1	6.6
Lending interest rate (percent, end of period)	11.3	11.3	11.3	11.3
Balance of payments				
Current account balance	273	-372	-832	-930
(In percent of Non-oil GDP)	16	-20	-41.8	-43.4
Trade of Goods	-1,959	-1,234	-885	-939
Exports of goods	-1,054	-346	73	83
Imports of goods	906	887	958	1,022
Trade of Services	-150	-154	-181	-207
Primary Income	2,452	1,091	316	303
of which: other primary income (oil/gas) 1/	1,106	409	0	0
Secondary Income	-69	-75	-81	-87
Overall balance	-102	-4	79	74
Public foreign assets (end-period) 2/	18,212	18,331	17,680	17,112
(In months of imports)	196	198	174	156
Exchange rates				
NEER (2010=100, period average)	162.9	...	...	...
REER (2010=100, period average)	137.9	...	...	...
Memorandum items				
Nominal Non-oil GDP (in millions of U.S. dollars)	1,672	1,833	1,992	2,140
Nominal Non-oil GDP per capita (in U.S. dollars)	1,256	1,357	1,454	1,540
(Annual percent change)	5.5	8.1	7.1	5.9
Crude oil prices (U.S. dollars per barrel, WEO) 3/	96	81	79	75
Petroleum Fund balance (in millions of U.S. dollars) 4/	17,379	17,503	16,772	16,130
(In percent of Non-oil GDP)	1,039	955	842	754
Public debt (in millions of U.S. dollars)	253	275	284	311
(In percent of Non-oil GDP)	15.1	15.0	14.2	14.5
Population growth (annual percent change)	1.6	1.4	1.4	1.4

Sources: Timor-Leste authorities; and IMF staff estimates and projections.
1/ Oil sector activities are considered non-resident activities in balance of payments statistics.
2/ Includes Petroleum Fund balance and the central bank's official reserves.
3/ Simple average of UK Brent, Dubai, and WTI crude oil prices based on October 2023 WEO assumptions.
4/ Closing balance.

INTERNATIONAL MONETARY FUND

DEMOCRATIC REPUBLIC OF TIMOR-LESTE

February 2, 2024

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION

KEY ISSUES

Context. Timor-Leste has made impressive progress since independence in 2002 but remains a fragile post-conflict nation with pressing development needs. With oil and gas production having recently come to a halt, progress on diversifying the economy and developing the private sector is urgently needed. Fiscal deficits are financed by the country's considerable Petroleum Fund savings, but regular large withdrawals are expected to lead to its full depletion by the end of the 2030s. A new coalition government—formed following parliamentary elections in May 2023—targets higher growth and achieving fiscal sustainability.

Recent developments and outlook. Growth is estimated to have slowed to 1½ percent in 2023 but is expected to recover to 3½ percent in 2024 supported by the new government's prioritization of public capital expenditure. Inflation remains high and averaged 8.4 percent in 2023 but is expected to ease to 3½ percent in 2024.

Themes of the Article IV. The discussions focused on ensuring that Timor-Leste's substantial savings are best utilized to support development objectives while achieving fiscal sustainability. Timor-Leste is one of the largest recipients of IMF CD resources in the region. Ongoing CD projects, including on revenue administration and statistics, are critical for strengthening Timor-Leste's institutional capacity and to support reforms, as discussed in the Country Engagement Strategy.

Policy recommendations. To develop a vibrant private sector, Timor-Leste should undertake an ambitious agenda of reforms. Public expenditure should be reduced to align it with the economy's absorptive capacity, and its quality improved including by further prioritizing spending on human and physical capital. Domestic revenue should be gradually mobilized. A medium-term fiscal framework should underpin these efforts by setting a clear roadmap to fiscal sustainability. To boost growth and diversify the economy, structural reforms should remove bottlenecks in the agriculture and tourism sectors and foster digitalization to boost productivity, while addressing legal constraints that hinder business operations and financial development.

Approved By
APD (Ranil Salgado) and SPR (Fabian Bornhorst)

Discussions took place in Dili during November 15–27, 2023. The staff team comprised Yan Carrière-Swallow (Head), Kohei Asao, Raju Huidrom, and Danila Smirnov (all APD). The team met with the Minister of Finance, the Governor of the Central Bank, the Minister of Petroleum and Mineral Resources, the Secretary of State for Vocational Education and Training, government agencies, development partners, the private sector, and civil society. Bernard Harborne and Alief Rezza (both World Bank) participated in several meetings. Ranil Salgado (APD) and Bruno Saraiva (OED) participated in policy discussions. Abdullah Alnasser and Nadine Dubost (both APD) assisted in the preparation of this report.

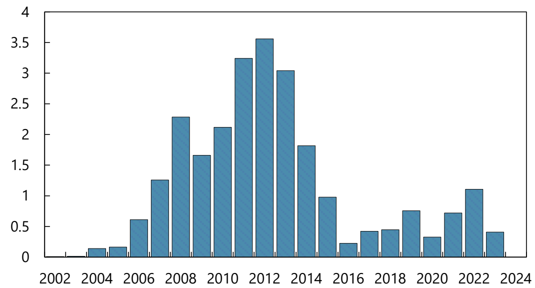
CONTENTS

ANNEXES

CONTEXT

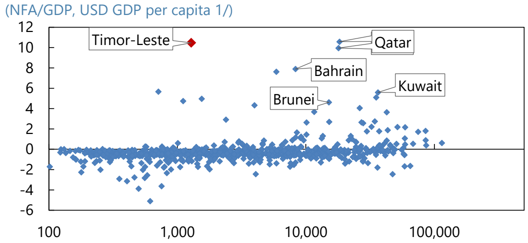
1. **Despite impressive gains since independence, Timor-Leste remains a fragile post-conflict nation with pressing development needs.** The economy is highly dependent on the public sector, which has been financed primarily by proceeds from offshore oil and gas production. A lack of economic diversification along with large fiscal and external imbalances contribute to Timor-Leste's fragility, which is explored in staff's first Country Engagement Strategy (Annex I).

Oil Revenues
($ billion)



Sources: Central Bank of Timor-Leste; and IMF staff estimates. (Projection for 2024)

Timor-Leste's Net Foreign Assets in Global Context
(NFA/GDP, USD GDP per capita 1/)



Sources: Lane and Milesi-Ferretti (2022), World Bank; and IMF staff calculations.
1/ Datapoint represents 10-year average Net Foreign Asset (NFA) position vs average GPD per capita in the same period. Data spans all IMF member countries up to 2022 and stretches back to 1970 for some countries.

2. **Sizable financial buffers were accumulated by saving natural resource revenues, but are gradually being depleted**. The national Petroleum Fund's (PF) balance stood at 1,043 percent of non-oil GDP in 2022, making Timor-Leste's Net Foreign Asset (NFA) position one of the highest in the world as a share of the domestic economy, and an outlier among countries at similar levels of per-capita income. But oil and gas production has recently come to a halt, and regular large withdrawals from the PF to finance fiscal deficits are expected to lead to its full depletion by the end of the 2030s.

3. **A new coalition government was formed following parliamentary elections in May 2023.** Despite pre-election uncertainty, the election and transfer of power went smoothly. The new government's agenda focuses on boosting growth and employment, reducing poverty, and achieving fiscal sustainability.

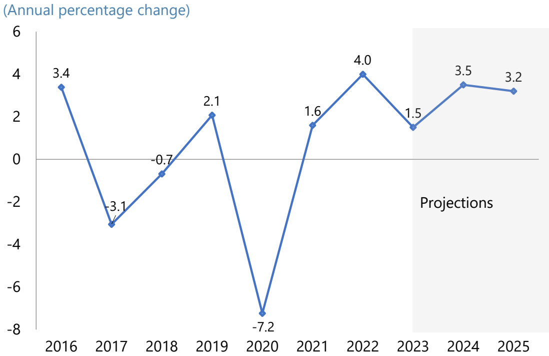
RECENT DEVELOPMENTS

4. **After recovering strongly in 2022, growth is estimated to have slowed in 2023 due to the strong fiscal drag.** Non-oil real GDP growth reached 4 percent in 2022, driven by the post-pandemic re-opening and a strong fiscal expansion. Growth slowed to 1½ percent in 2023 as fiscal policy contracted following difficulties in executing the budget surrounding the elections (¶16).

5. **Food prices and transport costs have driven a surge in inflation**. After a decrease in global food prices provided some relief through mid-2023, headline inflation proved more persistent than in other Asian EMDEs and rose again to 8.7 percent (y/y) in December 2023. This primarily reflects prices of food and non-alcoholic beverages, as well as alcohol and tobacco, which collectively

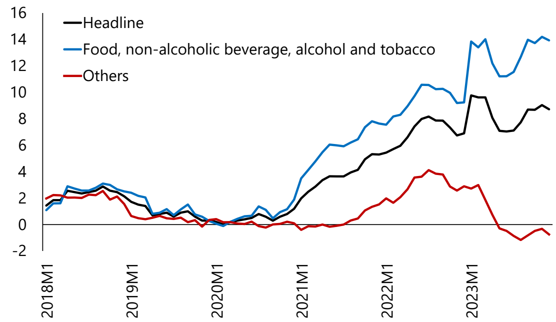
account for approximately 90 percent of the peak inflation rate.[1] Prices in other product categories have declined on average since May 2023, with subsidized energy prices subdued. The REER appreciated amidst the global strength of the US dollar, contributing to easing inflation.

Real Non-Oil GDP
(Annual percentage change)



Sources: General Directorate of Statistics; and IMF staff estimates.

Inflation, by Category
(In percent, y/y, 2018M1-2023M12)



Source: General Directorate of Statistics.

6. The fiscal position improved significantly in 2023. Difficulties in executing the budget surrounding the elections and power transfer restrained expenditure. On the revenue side, oil receipts of $410 million (through September 2023) exceeded the budgeted $115 million, while the reduction of import duties and sugar excises to alleviate cost of living pressures led to a small loss of revenue (around ½ percent of GDP). The fiscal deficit is estimated to have declined to 41 percent of non-oil GDP in 2023 from 58 percent in 2022. This implies a contractionary fiscal impulse of 17 percentage points of GDP in 2023 that weighed on growth, though the fiscal multiplier is thought to be low because of the low quality and high import content of public expenditure (Box 1).

7. The external sector position in 2023 remained substantially weaker than implied by fundamentals and desirable policies. The current account deficit (excluding oil revenues) remained large in 2023 (around 43 percent of non-oil GDP), reflecting the large fiscal imbalances and underdevelopment of the private sector. Under current policies, the current account deficit is expected to persist over the medium and long term. Consequently, the net International Investment Position (IIP) is projected to decline, eroded by persistent deficits. Reducing public expenditures and developing the non-oil economy would substantially reduce the current account imbalance over time (Annex II).

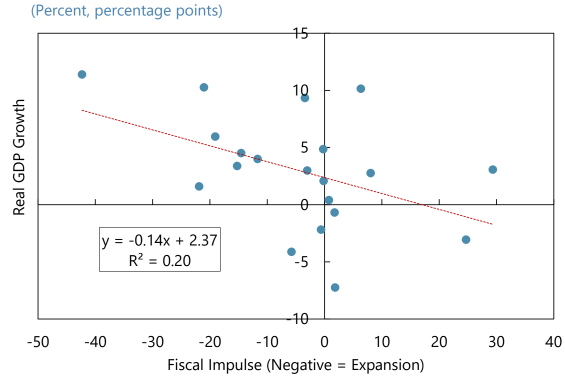
[1] The cigarette tax and import duties doubled in January 2023, which also boosted the 2023 CPI on a y/y basis. These measures were reverted in August 2023 as part of the 2023 rectification budget.

Box 1. The Impact of Fiscal Policy on Growth in Timor-Leste

In general, the size of the fiscal multiplier depends on country-specific features, fiscal composition, and macroeconomic conditions. The fiscal multiplier—the change in output due to a dollar increase in government spending—is a gauge of the impact of fiscal policy on activity. The size of the fiscal multiplier is smaller in economies with: (i) larger import intensity, due to larger leakages into import demand; and (ii) lower fiscal space due to larger crowding-out effects (Ilzetzki, Mendoza, and Végh 2013; Huidrom and others 2020). It also depends on the composition of expenditure: public investment tends to have larger multipliers than public consumption in developing economies (Ilzetzki, Mendoza, and Végh 2013). The efficiency of public investment is also an important determinant: the multiplier is smaller if project selection and execution are poor and only a fraction of the amount invested is converted into productive public capital stock (IMF 2014; IMF 2020). Finally, the multiplier depends on the business cycle, being larger during recessions than expansions (Auerbach and Gorodnichenko 2012).

For Timor-Leste, the size of the fiscal multiplier is thought to be low because of the low quality and high import content of public expenditure. In recent years, recurrent spending has comprised up to 90 percent of total expenditure, while subsidy schemes are poorly targeted. The budget execution rate of capital expenditure has been below 50 percent for the past three years. The economy is highly dependent on public spending, but a large share of final demand (notably food, fuel, automobiles, and machinery) is met via imports. Given these factors, the size of the multiplier in Timor-Leste is thought to be low, with estimates of around 0.1 (2022 Article IV staff report) and 0.2 (World Bank 2021). This falls in the estimated range of -0.3 – 0.8 reported in surveys for low-income countries (World Bank 2015), which is lower than recent panel estimates for advanced economies (Guajardo, Leigh, and Pescatori 2014) and emerging market economies (Carrière-Swallow, David, and Leigh 2021). While estimation of multipliers requires a causal identification of fiscal actions, the historical correlation between the fiscal impulse (change in the fiscal balance) and real GDP growth in Timor-Leste suggests that the fiscal multiplier is positive but small.

Real Growth vs Fiscal Impulse (2002-22)
(Percent, percentage points)



Source: IMF staff calculations.

Improving the quality and efficiency of spending could make fiscal policy more effective. Public spending should prioritize investment in physical and human capital. Additionally, the efficiency of spending should be improved via better project selection and execution, as part of broader public financial management (PFM) reforms with technical support from the IMF (¶18).

OUTLOOK AND RISKS

8. **Growth is projected to recover to 3½ percent in 2024.** Growth will be supported by higher execution of public spending, which is expected to prioritize capital expenditure more than in previous years. Robust growth in Timor-Leste's main export partners (e.g., Indonesia) will continue to support non-oil exports, albeit from a very low base.

9. Inflation is expected to ease in 2024. Given the large share of imported food, tobacco, and beverages in the CPI basket, the projected easing of global commodity prices is expected to lower inflation in Timor-Leste. Lower inflation in trade partners and the new government's decision to reverse the increase in taxes on imports, cigarettes, and sugar will also help lower inflation to 3½ percent in 2024. However, if the El Niño phenomenon persists, it could weigh on food production, leading to persistent inflationary pressures. Adverse commodity price developments fueled by geopolitical events could also contribute to elevated inflation.

10. Growth is expected to remain at the pre-pandemic average of 3 percent in the long term, but policy actions could accelerate it. Reaching an agreement on the Greater Sunrise natural gas field would serve as a fiscal lifeline, allowing Timor-Leste to delay a destabilizing fiscal cliff for an extended period. The new government demonstrates a strong commitment to developing the project. In the short to medium term, faster growth could be driven by reforms in the agriculture and tourism sectors. Over the longer term, raising the economy's potential growth rate requires consistent progress to address broad structural challenges, including economic diversification and human capital development. IMF capacity development (CD) will continue to help the authorities develop and implement necessary growth-enhancing reforms informed by past Fund advice, with 12 projects ongoing (Annex IV).

11. Risks to the outlook are tilted to the downside (Annex III). Near-term downside risks to growth include an abrupt onset of a global recession (shrinking the returns of the PF), heightened commodity price volatility (affecting food security through import prices), and extreme climate events. These could require a fiscal response, posing obstacles to expenditure restraint and adversely affecting the PF's balance. Achieving the political commitment to rationalize public expenditure would reduce uncertainty surrounding the medium-term outlook. Developing the Greater Sunrise oil field presents a large positive upside risk in the medium term.

Authorities' Views

12. The authorities broadly agreed with staff's assessment of the outlook and risks. For 2024, they project somewhat higher growth based on more optimistic paths for budget execution and donor support projects and agreed that inflation would moderate. They are committed to raising growth in the medium term, with higher and better-quality public spending and making progress on their reform agenda, which will support their growth target of 5 percent. The authorities agreed that global commodity and food prices are an important external risk and emphasized the upside risks to the outlook from negotiations on the Greater Sunrise oil fields. They broadly agreed with staff's assessment of the external sector and emphasized the need to diversify and develop the private sector to reduce imbalances going forward.

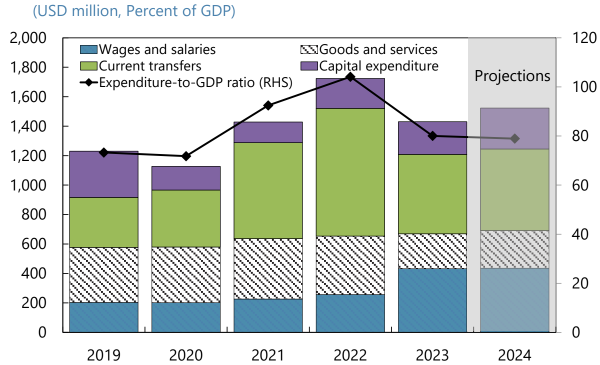
POLICY DISCUSSIONS

Policy discussions focused on how to best utilize Timor-Leste's substantial savings to support the country's development objectives and achieve the new government's priorities. To that end, fiscal policy should prioritize spending on human and physical capital and a better-targeted social safety net. To *achieve fiscal sustainability and avoid a destabilizing fiscal cliff, a medium-term consolidation plan is needed to gradually align the deficit with the PF's sustainable income stream. This should be supported by structural reforms to boost growth, initially focusing on agriculture and tourism. Over the medium term, the reform agenda should advance broad-based reforms that facilitate economic diversification, private sector development, and a deeper financial sector including the development of the fiscal, regulatory, and legal frameworks.*

A. Supporting Growth While Securing Fiscal Sustainability

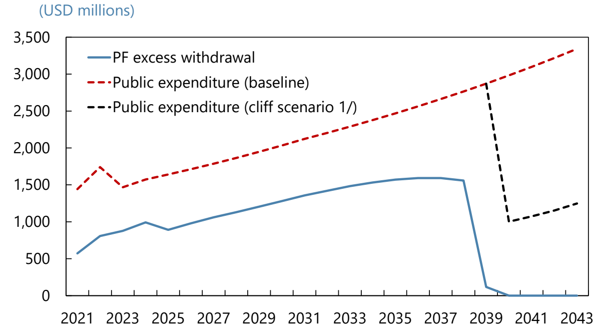
13. The 2024 budget includes a welcome prioritization of capital expenditure, but more efforts are needed to contain current expenditures. As envisaged in the 2024 budget, a modest rebound in expenditures is expected this year, including a welcome expansion of capital expenditures from a low base in 2023 and contained spending on transfers. Staff's baseline assumes that two-thirds of the budgeted investment can be executed in 2024, in line with the pre-pandemic track record and the new government's prioritization.[2] Following a surge in 2023, the wage bill is expected to remain high in 2024, with compensation related to participation in ASEAN and WTO accession processes offsetting the roll-off of temporary election workers. Recurrent spending will continue to make up two-thirds of total expenditure, and includes poorly targeted subsidy schemes. Staff recommend further containing current expenditure, including by shifting towards more targeted support to vulnerable households.

Public Expenditure
(USD million, Percent of GDP)



Sources: Ministry of Finance; and IMF staff calculations.

PF Excess Withdrawal and Public Expenditure
(USD millions)



Sources: Ministry of Finance; and IMF staff calculations.
1/ Upon full depletion of PF, public expenditure financed by domestic revenues and historical average of foreign loans.

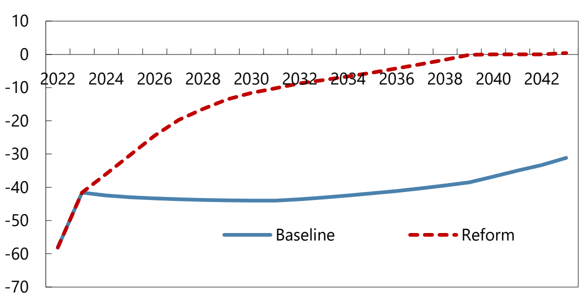
14. Deficits of around 43 percent of non-oil GDP over 2025-28 will be financed by withdrawals from the PF that far exceed its Estimated Sustainable Income. Over the medium term, the government expects to raise the budget envelope and the share of capital expenditure to meet its 5 percent growth target. Staff's baseline broadly reflects this fiscal path but assumes a more modest expansion in view of constraints from public procurement and investment systems and the economy's limited absorptive capacity. Staff project the fiscal stance to be mildly expansionary

[2] For spending on goods and services, the baseline assumes a slightly higher execution rate of 70 percent. In line with historical experience, assumed execution rates are much higher (around 95 percent) for spending on transfers, and wages and salaries.

during 2025-28, keeping growth slightly above its long-term rate of 3 percent. Fiscal deficits will remain high over the medium term, requiring excess withdrawals from the PF. Staff estimate the PF to be fully depleted by the end of the 2030s, which could lead to a fiscal cliff.[3] Notwithstanding this long-term challenge, the large buffer provided by the PF grants enough room for manoeuver to maintain a rating of moderate risk of debt distress in the Debt Sustainablity Analysis. In the short term, the large balance also provides space for fiscal policy to respond to adverse shocks, including natural disasters or spikes in global prices of imported food commodities.

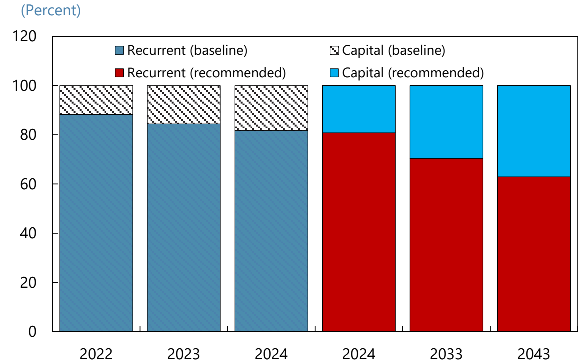
15. Avoiding the looming fiscal cliff requires an ambitious agenda of fiscal and structural reforms to align the budget with the economy's absorptive capacity. Staff recommend a reform scenario that achieves fiscal balance *(*aligning the deficit with the PF's sustainable income stream) within 10 years, underpinned by the adoption of a fiscal responsibility law and the formulation of a medium-term fiscal framework. The reform scenario includes expenditure restraint and rationalization (¶16), domestic revenue mobilization supported by improvements to tax administration (¶17), and structural reforms to boost growth (¶27-30). The gradual fiscal adjustment path and prioritization of growth-enhancing expenditures limit the growth costs from fiscal consolidation and allows for structural reforms to advance in parallel, accelerating private sector development. Given a more favorable fiscal position in 2023 than was earlier forecast, achieving balance within 10 years under the reform scenario now requires more moderate effort (DSA Annex). The reforms would also reduce the large external imbalance by reducing import-intensive public expenditures, helping to overcome the challenges of fragility (Annex I). An illustrative 'fast reform' scenario that achieves fiscal balance within five years (Box 2) would entail a greater cost to output and poverty in the short term, and the required pace of reforms may be too ambitious given the slow pace of past reforms. While the faster adjustment would result in the stabilization of the PF at a higher level—allowing for higher permanent income—staff assess the additional gains to be small.

Fiscal Primary Balance
(Percent of non-oil GDP)



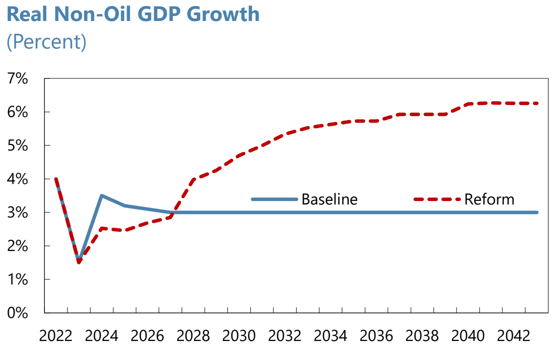
Source: IMF staff estimates.

Composition of Public Spending
(Percent)

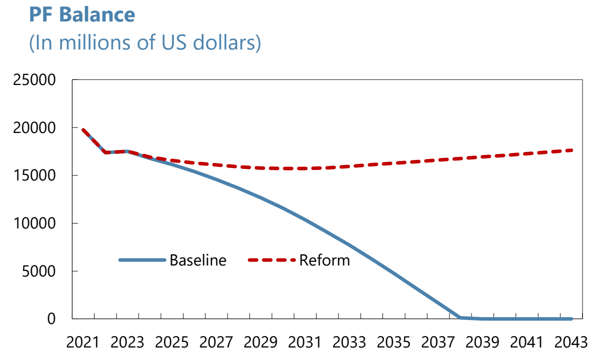


Sources: Ministry of Finance; and IMF staff calculations.

[3] The baseline assumes that once the PF is fully depleted in 2039, the fiscal deficit will be financed by a surge in external borrowing (see DSA Annex). The fiscal cliff emerges if external borrowing cannot be meaningfully scaled up from its historical trend. This would result in a financing shortfall and require a sharp contraction in public spending. The Ministry of Finance projects higher levels of public expenditure than staff over the medium term, and thus expects the PF to be fully depleted by 2034.



Source: IMF staff estimates.



Source: IMF staff estimates.

16. Fiscal reforms entail reducing public expenditure and improving its quality, including further shifting its composition to support growth. Staff recommend limiting recurrent expenditures on wages (by restraining public employment), goods and services (by improving procurement), and transfers while prioritizing spending on human capital (health and education), physical capital, and a better-targeted social safety net (World Bank 2021). The reform scenario entails gradually reducing the wage bill and transfers to around their respective pre-pandemic levels by 2033. Available costing estimates are not comprehensive but suggest that priority spending—including projects and additional support to boost digitalization, the agriculture and tourism sectors—would fit within the proposed budget envelope.

17. Domestic revenues should be mobilized gradually from a low base. The introduction of a value added tax and property tax (once the land registry is complete), and increasing the rates of the corporate income tax (to levels more in line with regional peers) would allow the authorities to achieve their goal of raising revenues from 10 percent to 15 percent of GDP over 5 years. The new government announced a plan to introduce a VAT, which is being supported by capacity development from PFTAC to prepare for its implementation (Annex IV). Staff recommend prioritizing the introduction of the VAT in 2024, alongside measures to strengthen tax administration: (i) modernize operations by upgrading human capacity and minimizing manual procedures in the tax administration system; (ii) develop a medium-term tax administration plan; (iii) implement institutional reforms to streamline the organizational structure of the tax authority; (iv) upgrade the tax procedure code; and (v) promote e-tax filing.

18. The introduction of a Fiscal Responsibility Law (FRL) and advancing PFM reforms would help improve fiscal discipline. Although the Petroleum Fund Law provides a sound benchmark for sustainable government spending, excess withdrawals have been the norm. The adoption of a well-designed medium-term fiscal framework is essential to enhance fiscal sustainability. An FRL, with technical support from the IMF, could help improve fiscal discipline by requiring the government to commit to a monitorable fiscal policy objective and to lay out a strategy to achieve that objective (Annex III in 2022 Article IV Consultation staff report). Addressing PFM weaknesses is also essential for strengthening budget credibility following very low execution in 2023 (relative to the original budget) and for improving the quality of government spending. Staff recommend to proceed with PFM reforms: (i) strengthen top-down budgeting and macroeconomic

Box 2. Staff's Baseline and Recommended Reform Scenarios

			Baseline			Reform (Recommended)			Fast Reform (Illustrative)		
	2022	2023	2024	2025-28	2039-43	2024	2025-28	2039-43	2024	2025-28	2039-43
	Percent of non-oil GDP (unless noted otherwise)										
Real non-oil GDP growth (in percent)	4.0	1.5	3.5	3.1	3.0	2.5	3.0	6.2	1.7	2.7	6.2
Revenue (excl. grants)	46.0	38.5	36.5	30.4	13.5	38.0	35.5	21.1	38.9	38.3	22.6
Domestic revenue	10.3	10.0	10.1	10.4	13.5	11.4	14.2	15.1	12.3	16.3	15.7
Estimated Sustainable Income	35.7	28.4	26.4	20.0	0.0	26.6	21.3	6.0	26.6	21.9	6.9
Expenditure	104.1	80.0	78.9	73.8	48.4	73.9	58.2	21.1	69.2	48.4	19.3
Recurrent	92.0	67.9	65.0	59.5	36.3	59.8	44.8	14.2	55.1	35.1	12.5
Capital	12.1	12.1	14.0	14.3	12.1	14.1	13.3	6.9	14.1	13.3	6.9
Net lending/borrowing	-58.2	-41.6	-42.5	-43.4	-34.9	-36.0	-22.7	0.1	-30.5	-10.3	3.3
Financing											
PF excess withdrawals	48.3	48.0	49.8	42.7	0.4	43.3	21.0	0.0	37.9	8.0	0.0
PF closing balance ($ million)	17,379	17,503	16,774	14,938	0	16,910	16,207	17,266	17,023	17,053	19,659
Current account balance	16.3	-20.4	-42.0	-45.5	-38.6	-38.0	-33.9	-6.6	-34.5	-26.1	-4.6

Source: IMF staff estimates.

Recommended Measures Underpinning the Reform Scenario

Expenditure reforms:
(i) Prioritize spending on human capital (health and education) and physical capital; (ii) prioritize improvements to social safety nets and manage costs through better targeting to the most vulnerable; (iii) contain the rise in the wage bill by restraining public employment; (iv) curb the budget for goods and services by improving procurement; and (v) limit public transfers that do not safeguard the poor. (vi) Proceed with PFM reforms: strengthen top-down budgeting to improve budget credibility; upgrade framework used for public investment management to better select projects; and establish strong governance safeguards and transparent fiscal reporting.

Domestic revenue mobilization:
(i) Introduce a value-added tax; (ii) increase corporate income tax rates to levels more in line with regional peers; and (iii) adopt a property tax once the land registry is complete.

Tax administration:
(i) Modernize operations by upgrading human capacity and minimizing manual procedures in the tax administration system; (ii) develop a medium-term tax administration plan; (iii) institutional reforms to streamline the organizational structure of the tax authority; (iv) upgrade the tax procedure code; and (v) promote e-tax filing.

Structural reforms to boost growth:
(i) Agriculture: improve productivity through targeted public support for expanding coffee production and the shift to higher-value commodities; (ii) tourism: public investment to expand airport capacity; (iii) progress in regional integration, including through ASEAN accession; (iv) boost human capital (improving education quality) and strengthen vocational education and training; (v) improve business environment by removing legal constraints, including the land registry; and (vi) stronger governance, better enforcement of legal contracts, and investment in digital infrastructure.

Source: IMF staff.

forecasting tools to improve budget credibility and boost execution rates; (ii) upgrade the framework used for public investment management to better select projects; and (iii) establish strong governance safeguards and transparent fiscal reporting. IMF CD supported these initiatives

(Annex IV) and is expected to continue doing so, as described in the Country Engagement Strategy (Annex I). Improving the quality and efficiency of spending, as part of these broader PFM reforms, would also make fiscal policy more effective (Box 1).

Authorities' Views

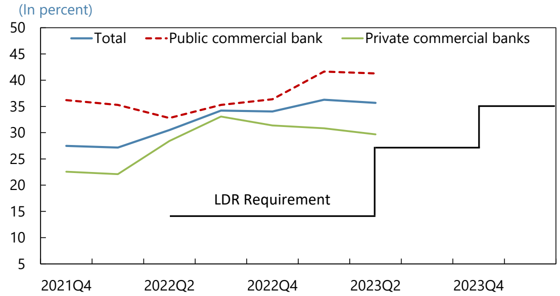
19. The authorities are committed to boosting growth by improving the quality of public expenditure. The Ministry of Finance (MOF) underscored the importance of strengthening budget credibility, including by improving execution rates and coordination with line ministries and development partners, and by strengthening the legal framework. They are prioritizing upgrades to public procurement—including human resources—that will improve the efficiency of public expenditure and ensure that Timor-Leste's considerable public savings are well spent. To this end, they highlighted progress on PFM reforms and concurred with staff that further reforms—along with the adoption of a Fiscal Responsibility Law—could help improve fiscal discipline. The MOF partly attributed high recurrent spending in the 2024 budget to ASEAN and WTO accession initiatives (wages and salaries) and measures to alleviate the burden of high inflation (transfers) but noted that these will be reviewed in the 2025 budget.

B. Reforms to Promote Financial Deepening and Inclusion

20. The financial system remains relatively shallow, and systemic risk appears low despite a recent acceleration of credit growth. Timor-Leste has low financial depth, with credit-to-GDP ratio at 24 percent in 2022. Credit growth from the banking sector surged to 37 percent (y/y) in July 2023, with new lending mainly directed to a relatively narrow pool of high-quality borrowers by the state-owned commercial bank, which was recapitalized in 2022 and as of September 2023 holds a third of the banking sector as measured by assets. The aggregate ratio of non-performing loans (NPL) remains low (below 2.4 percent), but credit risk should continue to be closely monitored. The banking sector remains well capitalized and liquid, with a loan-to-deposit ratio of 36 percent. Banks' large placements in overseas financial markets do not involve foreign exchange (FX) risk as investments are placed in USD-denominated assets, but give rise to limited interest rate risk. Advancements in adopting IFRS 9 and Basel III regulatory principles should continue, informed by capacity development on financial sector supervision.

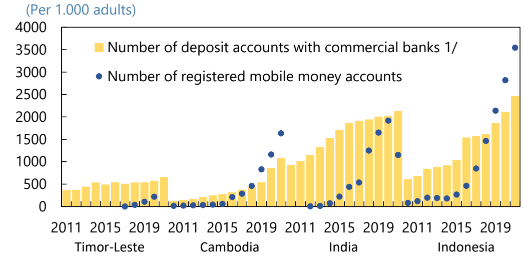
21. The central bank raised the minimum loan-to-deposit ratio (LDR) to encourage consumer and Micro, Small, and Medium Enterprise (MSME) credit, but the measure's efficacy appears limited. To boost credit, the central bank introduced a scheduled increase of the minimum loan-to-deposit (LDR) ratio to 35 percent by end-2023, with any shortfall to be placed in an unremunerated account at the central bank. The efficacy of this measure, however, appears to be limited. While aggregate credit has accelerated, most is due to lending by the state-owned bank, which already exceeded the LDR floor prior to the implementation of the measure. Private commercial banks have refrained from significantly expanding lending, citing structural impediments as bottlenecks, and some report a reduced willingness to accept new deposits, suggesting a weakening of incentives for intermediation. Staff recommend against raising the LDR floor until structural impediments to prudent lending are adequately addressed and banks and supervisors have had the opportunity to evaluate credit risk emanating from new borrowers more effectively.

Loan/Deposit Ratio
(In percent)



Source: Central Bank of Timor-Leste, BNCTL.

Financial Institutions Accessibility
(Per 1.000 adults)



Source: Financial Access Survey (FAS), with 2022 being the latest available data.
1/ Number of depositors with commercial banks used as a proxy for Timor-Leste, due to the data unavailability

22. A healthy process of financial deepening and inclusion requires the removal of structural impediments to lending, supported by the development of digital financial services. In the baseline, credit to the private sector is expected to grow in line with non-oil GDP, but financial deepening could be accelerated if reforms are undertaken. Impediments to lending should be addressed, including an inadequate framework for securing collateral for loans; absence of common accounting standards for corporate financial statements; and a complex and incomplete framework of banking regulations. Efforts to continue strengthening the provision of digital financial services should continue, as they expand financing opportunities—particularly for MSMEs with thin credit files—and nurture an efficient payments architecture. Digital systems can also improve the transparency of financial transactions, facilitating tax administration and its governance. AML/CFT deficiencies should be addressed to ensure compliance with the FATF standards.

23. Addressing legal constraints, resolving impediments to securing loan collateral, and strengthening digital financial services will support financial deepening. The central bank should introduce the requirement for companies to prepare financial statements under a common accounting standard. It should continue the work on the new banking law to modernize the regulatory framework, and IMF staff stand ready to assist. Effective electronic payment systems are needed, and the adoption of mobile money accounts should be promoted. Given the widespread availability of mobile phones, efforts to strengthen digital financial services, such as P24/e-wallet networks and the Digital Village Program, should be continued. The supervisory framework for non-bank financial companies should be completed to ensure a healthy process of financial deepening.

24. The authorities expressed interest in understanding the implications of dollarization and possible alternatives. Using the U.S. dollar as the currency has so far served Timor-Leste well. If a national currency were to be issued in the future, the benefits of monetary autonomy could only be accrued after implementing necessary reforms, including the reduction of fiscal imbalances that could otherwise give rise to fiscal dominance. Other reforms would be needed to create a setting for effective monetary policymaking, including financial market development, regulatory reforms, and building technical capacity within the central bank.

Authorities' Views

25. The authorities agreed that financial deepening and inclusion require the removal of structural impediments. The central bank noted that the loan-to-deposit ratio (LDR) requirement is expected to encourage private banks to expand credit, but they have no intention to raise it further unless the attendant risks are clearly managed and the measure is proven to be effective. At the same time, they noted that deeper structural reforms are needed to incentivize private credit, and are prioritizing legal reforms with assistance from development partners. The authorities expressed an interest in further improving their reporting of Monetary and Financial Statistics (MFS) and financial soundness indicators (FSI). They agreed with the need for seamless supervision of non-bank financial institutions as the electronic payment systems develops. They are awaiting the Asia-Pacific Group's assessment of Timor-Leste's AML/CFT framework—expected to be completed in 2024. On the possible introduction of a national currency, the authorities agreed that a key prerequisite is to bring fiscal policy on a more sustainable footing.

C. Structural Reforms for Sustainable Growth and Diversification

26. Structural reforms are crucial to support diversification, private sector development, and sustainable growth. With GNI per capita of $1,970 in 2022 and pre-pandemic growth averaging around 3 percent, there is an urgent need to diversify and develop the private sector. Staff believe that an ambitious agenda of sector-specific and broad-based reforms that alleviate the economy's structural impediments—including weak governance, legal and regulatory constraints—could boost growth to around 5 percent by 2030, which is within the range of empirical estimates for this type of reform package (IMF 2023). Timor-Leste is vulnerable to risks related to climate change and natural disasters (Annex I and Annex III). Investing in climate-resilient infrastructure remains a key priority for sustainable growth (2022 Article IV staff report), but new external financing to address it has not been secured since the last Article IV.

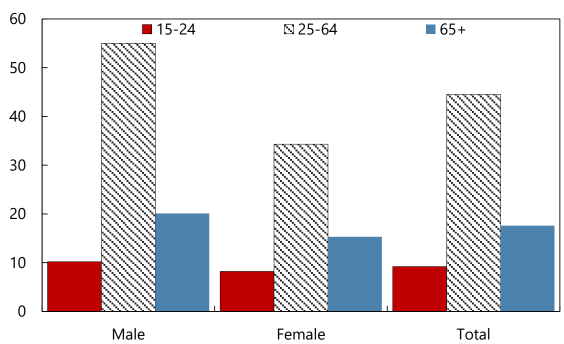
27. Targeted reforms should initially seek to address bottlenecks in the agriculture and tourism sectors, while broad-based reforms are needed over the medium term. The scale of labor and product markets is small, similar to other Small Development States (SDS). Over 60 percent of the workforce is employed in agriculture, with many limited to subsistence farming. Productivity in the sector should be increased through targeted public support for expanding coffee production and the shift to higher-value commodities (World Bank 2023). In the tourism sector, private investment should be facilitated by addressing legal constraints (¶23) and through public investment to increase the capacity of Dili's international airport. Staff recommend prioritizing regional integration through the removal of non-tariff barriers, including as part of accession to ASEAN and the WTO. This would create opportunities for Timor-Leste as a tourism destination and eventually in other sectors as the country joins dynamic regional value chains.

28. Boosting digitalization would improve productivity, support financial development and inclusion, and facilitate tax administration. Adoption of digital technologies would boost productivity across industries—including in agriculture—supported by the completion of a submarine cable to improve internet connectivity. Digitalization would also support financial deepening (¶22) and facilitate tax administration, including by promoting e-tax filing (¶17).

29. Reforms to develop human capital are needed to unlock Timor-Leste's large demographic dividend. Currently, 40 percent of the population is below the age of 15 years. Timor-Leste has made considerable progress in educational enrollment but still scores low on standard human capital metrics. Notably, enrollment in pre-primary school lags peers and the overall quality of education is weak (World Bank 2020). Labor force participation is lower than peers due to weak human capital, insufficient job creation in the private sector, and potentially high reservation wages (World Bank 2023). Participation is lower among women and the young; women are also more likely to be employed in the informal sector. Staff recommend better-targeted spending on education and human capital, and strengthening vocational education and training.

30. Strengthening governance and improving the business environment through regulatory reforms are essential to foster private investment. Indicators of governance and rule of law in Timor-Leste have shown improvement, but still lag behind peer countries. The following legal constraints that hinder business operations need to be addressed urgently to strengthen governance and the rule of law: (i) incomplete licensing requirements generate regulatory uncertainty and hinder business creation; (ii) poorly-defined property rights, including due to lack of a land registry; (iii) costly contract enforcements; and (iv) lack of an insolvency framework. These efforts can be complemented by continued efforts to develop the justice system, including by training more lawyers and judges.

Labor Participation Rate, by Age
(Percent)



Sources: Timor-Leste General Directorate of Statistics and Ministry of Finance.

The Worldwide Governance Indicators: Rule of Law[1]
(Ranking in percentile; 2021)

Source: Daniel Kaufmann and Aart Kraay (2023).
1/ Comparator Group: Cambodia, Fiji, Maldives, Myanmar, Lao PDR, PNG, Solomon Island, Vanuatu.

31. The quality and frequency of macroeconomic statistics should be enhanced with support from IMF CD. While data remain broadly adequate for surveillance and there has been steady progress, limited capacity has led to shortcomings in data provision. Ongoing CD from the IMF's Statistics Department helped to address delays in reporting Government Financial Statistics (GFS), but further improvements are needed to resolve the discrepancies between non-financial and financial transactions for GFS. Improvements to the quality and frequency of national accounts and balance of payments data are needed to alleviate the departures from the internationally accepted standards and practices of compiling the External Sector Statistics (ESS) (Annex IV). Also, some key

FSIs (e.g., non-performing loan ratio) are not periodically provided. The authorities have requested CD assistance to enhance the FSI and MFS, which will improve monitoring of the financial sector.

32. The IMF's continuous engagement is essential to overcome the challenges of fragility, in the context of the Country Engagement Strategy (Annex I).Implementation of past Fund advice has been partial, with the most traction in reforms of the financial sector regulatory and supervisory framework (Annex V). The new government's policy priorities also align closely with past Fund advice in other areas, including VAT implementation, PFM reforms, and digitalization. Given the active participation of many international development partners in Timor-Leste, coordination across stakeholders is crucial and should be improved. Deepening bilateral engagement with the Fund could center on the development of a medium-term fiscal framework, with the Country Engagement Strategy playing a key role in fostering this engagement.

Authorities' Views

33. The authorities broadly shared staff's diagnosis of the structural impediments to inclusive growth and underscored their commitment to pursuing an investor-friendly agenda of reforms. While they concurred with staff that initial reforms should focus on agriculture and tourism, they recognize the need for developing concrete plans and efficient implementations. They expect internet connectivity to improve upon the completion of the submarine cable in 2024. On the labor market, they agreed on the need to improve education quality and strengthen vocational education and training, but stressed budget and capacity constraints. The authorities envisage improved regional integration following accession to ASEAN and the WTO. They welcomed CD support from the IMF and other development partners, including on improvements to macroeconomic statistics. They saw value in staff's Country Engagement Strategy, including its assessment of fragility drivers and the IMF's policy priorities, and underscored the importance of achieving greater coordination across development partners.

STAFF APPRAISAL

34. The prioritization of public capital expenditure is expected to support growth in 2024. Following a slowdown in 2023 due to election-related fiscal drag, growth will recover to 3½ percent in 2024, supported by an increase in public capital expenditure in the 2024 budget. A projected decline in global commodity prices will help ease inflation to 3½ percent in 2024. In the long run, growth is expected to remain modest at around 3 percent. The external sector position in 2023 was substantially weaker than implied by fundamentals and desirable policy settings.

35. Risks to the outlook are tilted to the downside. Near-term downside risks to growth include an abrupt onset of a global recession and heightened commodity price volatility. These could require a fiscal response, posing obstacles to expenditure restraint and adversely affecting the PF's balance. Achieving the political commitment to rationalize public expenditure would reduce uncertainty surrounding the medium-term outlook. Developing the Greater Sunrise oil field presents a large upside risk in the medium term.

36. To achieve sustainable development, an ambitious agenda of reforms is required to align the budget with the economy's absorptive capacity. A key policy priority is to ensure that Timor-Leste's substantial savings are best utilized to support development objectives while achieving fiscal sustainability. Although the PF remains sizable for now and Timor-Leste remains at moderate risk of overall and external debt distress, large fiscal imbalances over the medium term would fully deplete the PF by the end of the 2030s. Fiscal and structural reforms are needed to secure fiscal sustainability, and would also strengthen the external sector position and help overcome the challenges of fragility.

37. Public expenditure should be reduced, and its quality further improved, while domestic revenue should be gradually mobilized. While the 2024 budget includes a welcome expansion of capital spending, public expenditure should be reduced and its quality improved, including by further shifting its composition to support growth and protect the vulnerable. On revenue mobilization, reform priorities include the introduction of the VAT in 2024, alongside measures to strengthen tax administration. These fiscal efforts should be underpinned by the adoption of a fiscal responsibility law and the formulation of a medium-term fiscal framework.

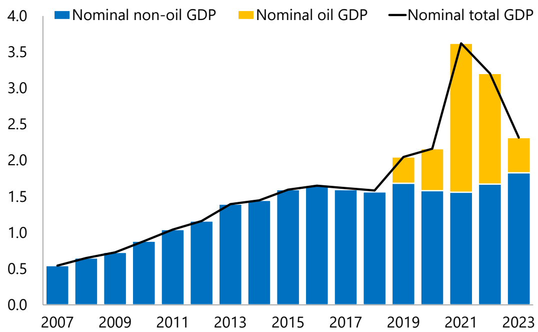
38. Fiscal efforts should be combined with structural reforms to boost growth, promote healthy financial deepening, and encourage diversification. Reforms should initially seek to remove bottlenecks in the agriculture and tourism sectors and foster digitalization to boost productivity. Legal and regulatory constraints that hinder business operations and financial development should also be addressed. Ongoing efforts to strengthen the rule of law should continue, including by addressing AML/CFT deficiencies, as progress would help reduce fragility (Annex I). Efforts to strengthen the provision of digital financial services should continue. Over the medium term, broad-based reforms are needed, including progress in regional integration through the reduction of non-tariff barriers, and boosting human capital by improving education quality and strengthening vocational education and training.

39. It is proposed that the next Article IV consultation with Timor-Leste takes place on the standard 12-month cycle.

Figure 1. Timor-Leste: Real Sector Developments

Oil production is included in GDP since 2019 following the Maritime Boundaries Treaty with Australia.

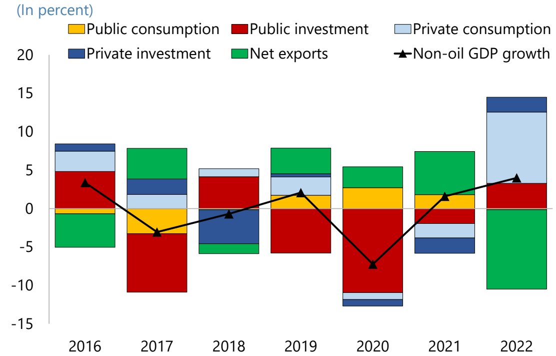
Nominal GDP: Total, Oil, and Non-Oil
(In billions of US dollars)



Sources: General Directorate of Statistics; and IMF staff estimates.

While the contribution from private sector is increasing, non-oil GDP has been historically driven by government spending on the demand side…

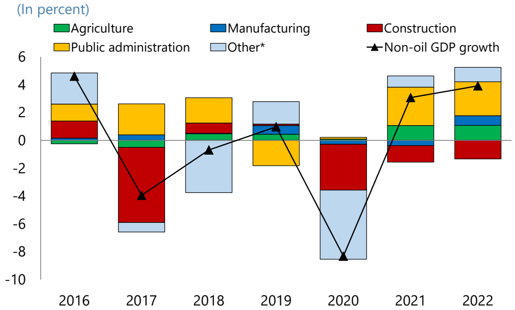
Real Non-Oil GDP Expenditure: Contributions to Growth
(In percent)



Source: General Directorate of Statistics; and IMF staff estimates.

…and by construction and public administration on the supply side.

Real Non-Oil GDP Production: Contributions to Growth
(In percent)

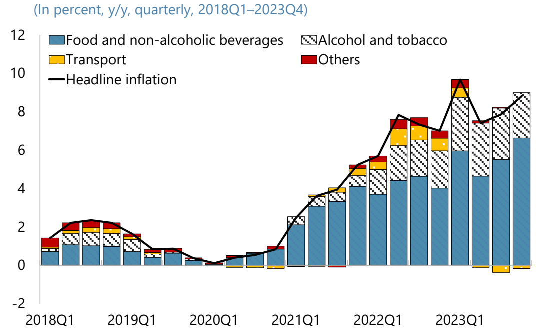


*Other includes wholesale and retail trade, real estate services, and other activities.

Source: General Directorate of Statistics.

Headline inflation remains elevated, largely reflecting rising food and alcohol prices…

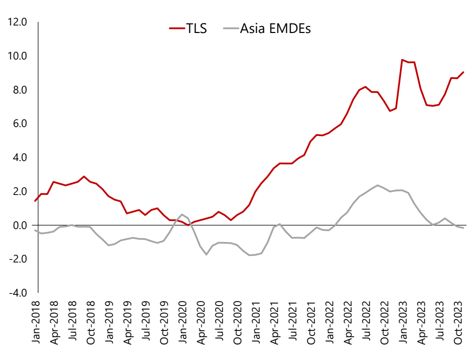
Contribution to Headline Inflation
(In percent, y/y, quarterly, 2018Q1–2023Q4)



Sources: General Directorate of Statistics; and IMF staff estimates.

….and inflation remains substantially higher than other Asian economies….

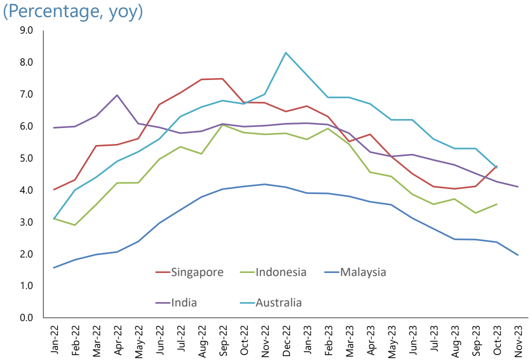
Headline Inflation
(Percentage, yoy)



Sources: Haver Analytics; and IMF staff calculations.

….with Timor-Leste's main trading partners experiencing deceleration of inflation in 2023.

Core CPI: Trade Origin Economies
(Percentage, yoy)

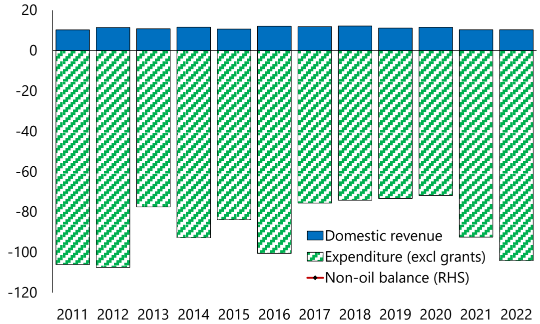


Sources: Haver Analytics; and IMF staff calculations.

Figure 2. Timor-Leste: Fiscal Sector Developments

Non-oil domestic revenue has been financing a small fraction of government spending.

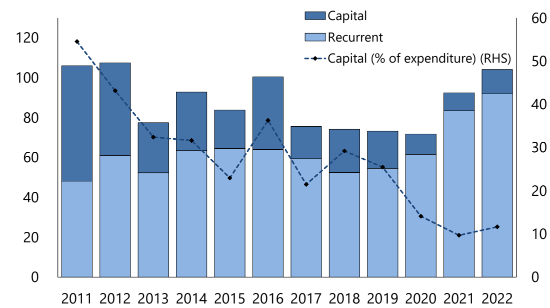
Non-Oil Balance
(In percent of non-oil GDP)



Sources: Ministry of Finance of Timor-Leste; IMF staff calculations and estimates.

While the share of capital spending has fallen in recent years…

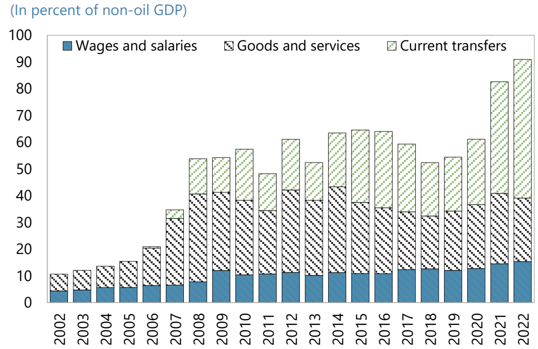
Expenditure Shares
(In percent of non-oil GDP, excl. donor projects)



Sources: Ministry of Finance of Timor-Leste; IMF staff calculations and estimates.

…recurrent spending has surged, amounting to nearly 90 percent of non-oil GDP in 2022.

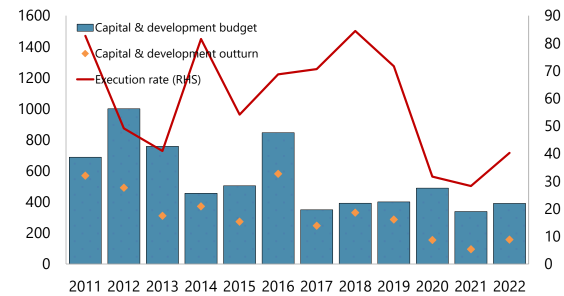
Recurrent Spending
(In percent of non-oil GDP)



Sources: Ministry of Finance of Timor-Leste; IMF staff calculations and estimates.

The execution rate for capital spending has been below 50 percent since 2020.

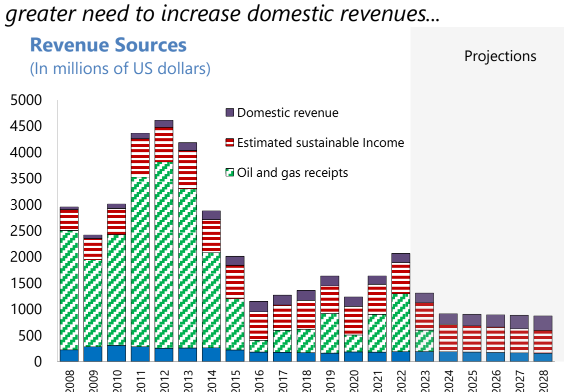
Capital and Development Expenditure: Budget and Execution Rate
(In millions of US dollars (LHS) and percent (RHS))



Sources: Ministry of Finance of Timor-Leste; IMF staff calculations and estimates.

With oil and gas receipts depleting in 2023, there is a greater need to increase domestic revenues…

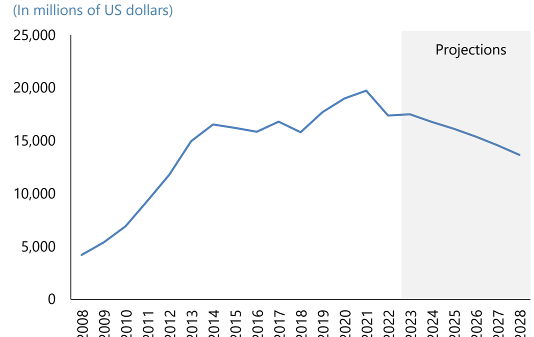
Revenue Sources
(In millions of US dollars)



Sources: Ministry of Finance of Timor-Leste; IMF staff calculations and estimates.

…and to reduce excess withdrawals to avoid depleting the Petroleum Fund.

Petroleum Fund Balance
(In millions of US dollars)



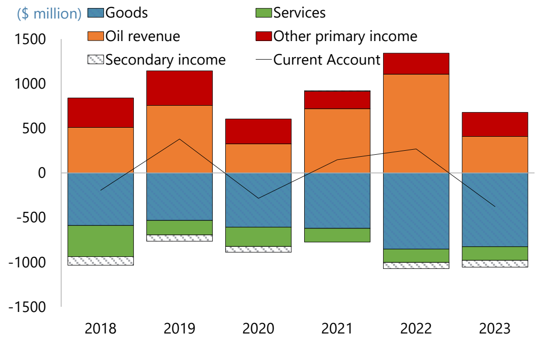
Sources: Ministry of Finance of Timor-Leste; IMF staff calculations and estimates.

Figure 3. Timor-Leste: External Sector Developments

A sharp decline in oil revenues has pushed the current account into deficit.

Current Account Balance

($ million)

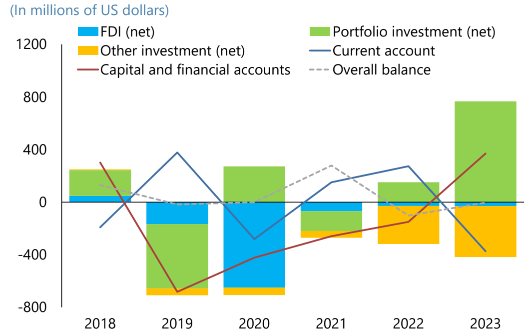


Sources: Central Bank of Timor-Leste; and IMF staff estimates.
(Estimation for end-2023 for all figures on this page)

Current account deficits have largely been financed by withdrawals from the PF (portfolio investment).

Financial Account Balance

(In millions of US dollars)

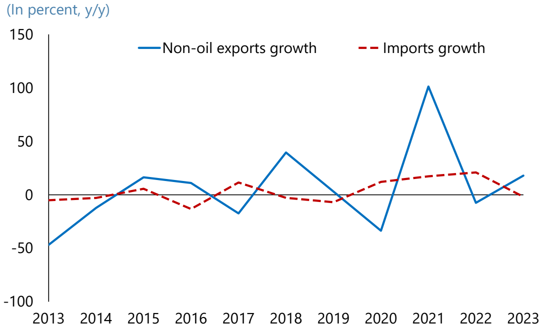


Sources: Central Bank of Timor-Leste; and IMF staff estimates.

Non-oil exports remain highly volatile…

Goods Exports and Imports Growth

(In percent, y/y)

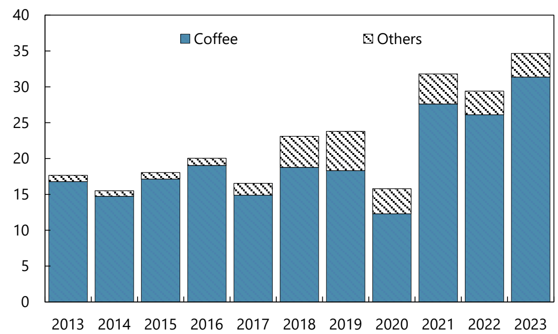


Sources: Central Bank of Timor-Leste; and IMF staff estimates.

…and are very small relative to the economy, with coffee the largest export product after oil/gas.

Non-oil Exports

(In millions of US dollars)

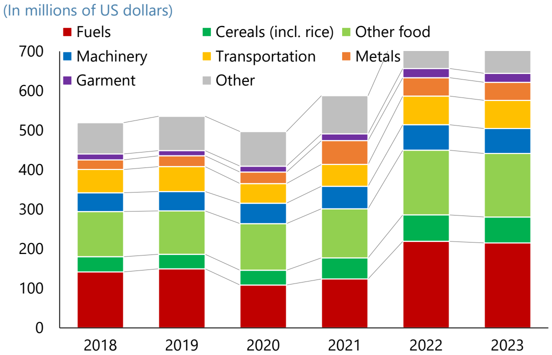


Sources: Central Bank of Timor-Leste; and IMF staff estimates.

Fuel and food account for more than half of total goods imports.

Goods Imports

(In millions of US dollars)

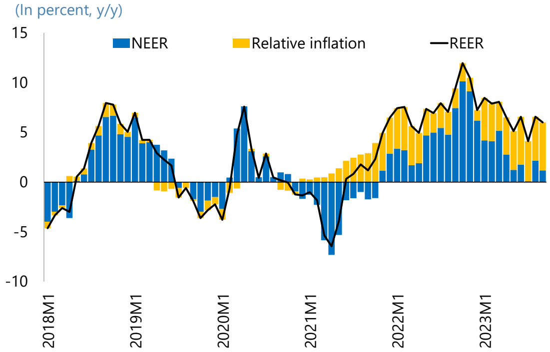


Source: General Directorate of Statistics.

The REER depreciated during the pandemic, but has appreciated recently amid global US dollar strength.

Real Effective Exchange Rate: Contribution to Change

(In percent, y/y)

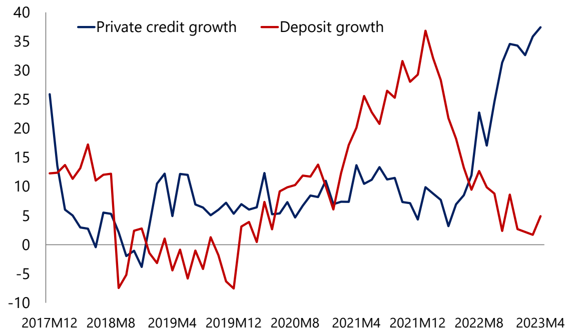


Source: Central Bank of Timor-Leste.

Figure 4. Timor-Leste: Monetary and Financial Sector Developments

Private sector credit growth has surged recently, driven by lending by the state-owned commercial bank.

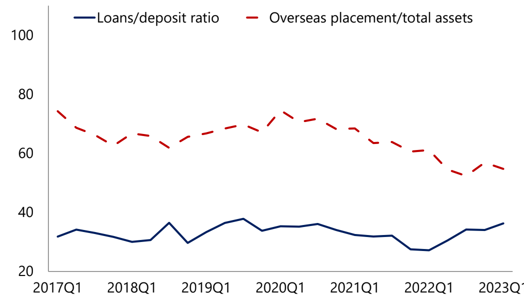
Credit and Deposit Growth
(In percent, year-on-year)



Source: Central Bank of Timor-Leste.

The banking sector is highly liquid with a large overseas placement of bank assets.

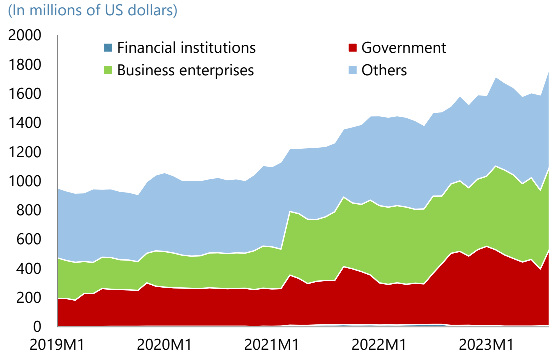
Liquidity Ratios
(In percent)



Source: Central Bank of Timor-Leste.

Deposits by the private sector drove the surge in deposits in 2021, while those of the public sector rose in 2022-23.

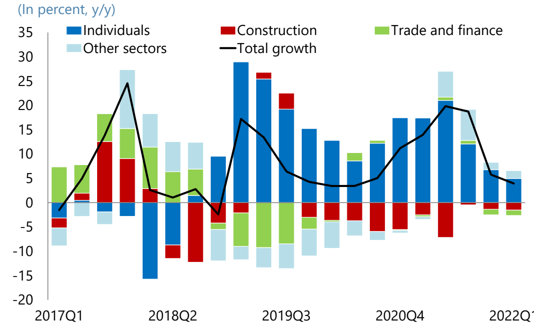
Deposits by Type of Depositors
(In millions of US dollars)



Source: Central Bank of Timor-Leste.

Recent private sector credit growth has mainly been directed to high-quality borrowers.

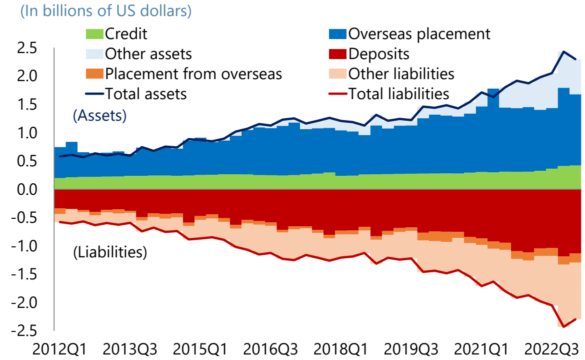
Loans to Private Sector: Contribution to Growth
(In percent, y/y)



Source: Central Bank of Timor-Leste.

Overseas placement of assets constitutes a significant share of the assets of the banking sector.

Banking Sector Balance Sheet
(In billions of US dollars)



Source: Central Bank of Timor-Leste.

NPLs remain low but vigilance is needed.

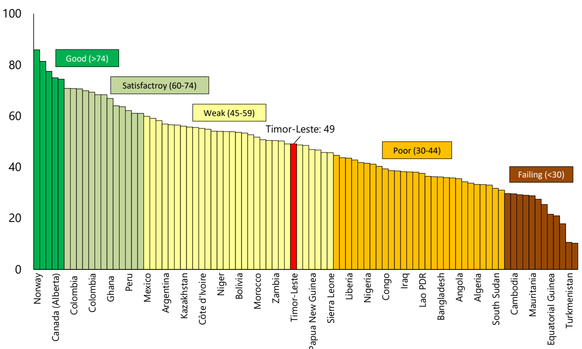
NPL Ratio
(In percent)

Source: Central Bank of Timor-Leste.

Figure 5. Timor-Leste: Business Environment and Governance

The governance of Timor-Leste's Petroleum Fund is satisfactory by international standards, and...

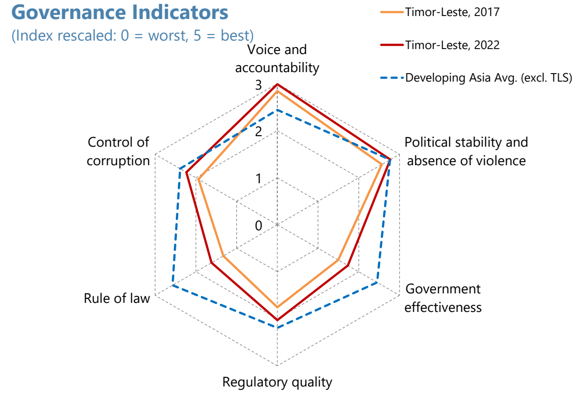
Resource Governance Index
(Index ranges from 0-100, higher is better, 2017)



Source: Natural Resource Governance Institute.

...the perceived governance of the public sector is improving but with some areas of weakness.

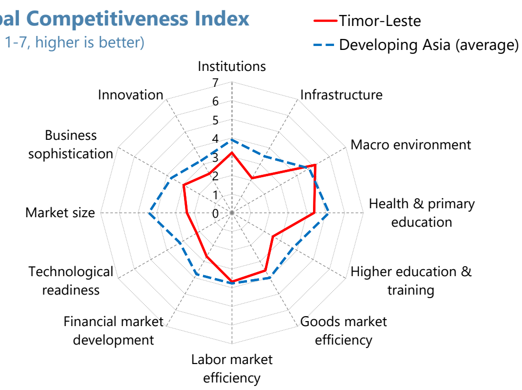
Governance Indicators
(Index rescaled: 0 = worst, 5 = best)



Source: Natural Resource Governance Institute.

Education and infrastructure gaps undermine competitiveness.

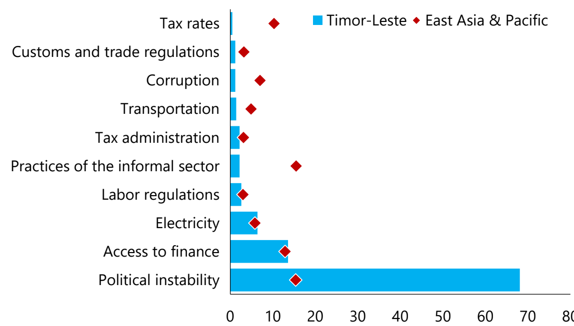
Global Competitiveness Index
(Score 1-7, higher is better)



Note: Timor-Leste for 2014-15 (data unavailable for 2017-18); Developing Asia for 2017-18.
Source: Natural Resource Governance Institute.

Political instability and limited financial access are among the major business constraints perceived by firms.

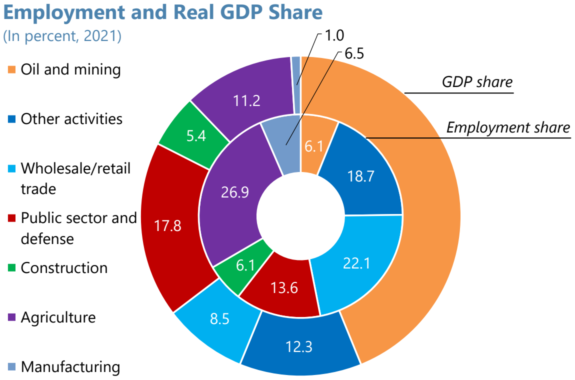
Top Ten Business Environment Constraints
(Percent of firms choosing as their biggest obstacles, 2021)



Source: World Bank Enterprise Surveys.

Despite a large share of employment in the agriculture and services sectors, their shares in GDP remain small...

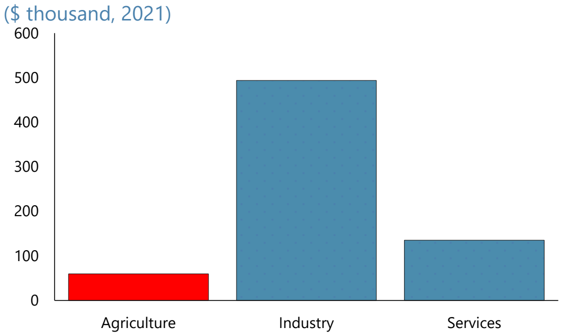
Employment and Real GDP Share
(In percent, 2021)



Source: General Directorate of Statistics and Ministry of Finance.

...driven by very low labor productivity.

Labor Productivity
($ thousand, 2021)

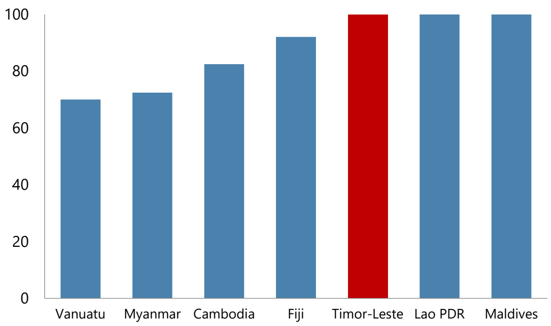


Source: National Institute Of Statistics Timor-Leste.

Figure 6. Timor-Leste: Challenges to Growth—Comparison with Regional Peers

Access to electricity has improved considerably and electricity tariffs are largely subsidized…

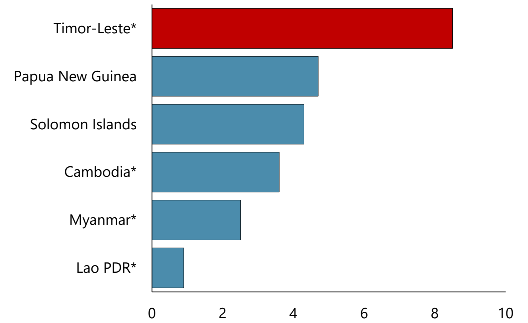
Access to Electricity
(In percent of population, 2021)



Source: World Bank Development Indicators.

…but losses due to electrical outages are high.

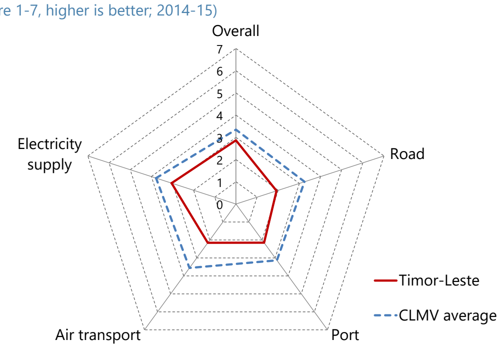
Value of Loss due to Electrical Outages
(In percent of sales of affected firms, 2021)



* 2021 data for Timor-Leste, 2018 data for Lao PDR, 2016 data for Cambodia and Myanmar, 2015 data for the rest countries.

The perceived quality of infrastructure is lower than regional peers.

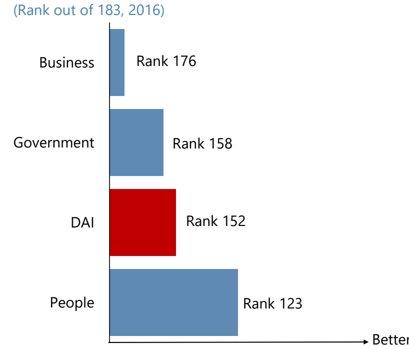
Quality of Infrastructure
(Score 1-7, higher is better; 2014-15)



Source: WEF Global Competitiveness Index.

Mobile penetration is high but digital adoption in business is at a low level.

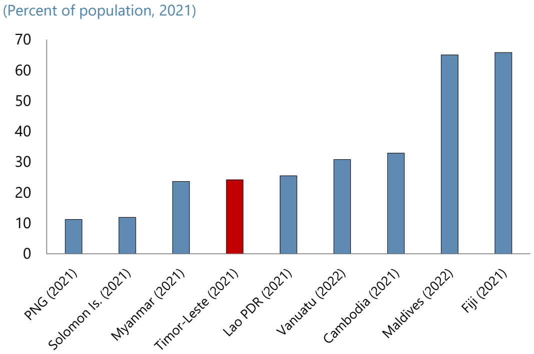
Digital Adoption Index
(Rank out of 183, 2016)



Source: World Bank, World Development Report 2016.

Access to the internet is low…

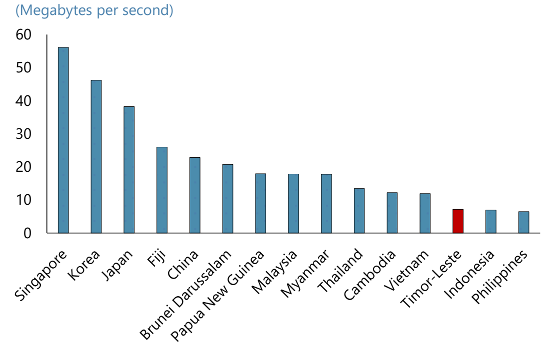
Individuals Using the Internet
(Percent of population, 2021)



Source: World Bank Development Indicators.

…and the service has poor quality.

Southeast Asia: Average Internet Speeds in 2020
(Megabytes per second)

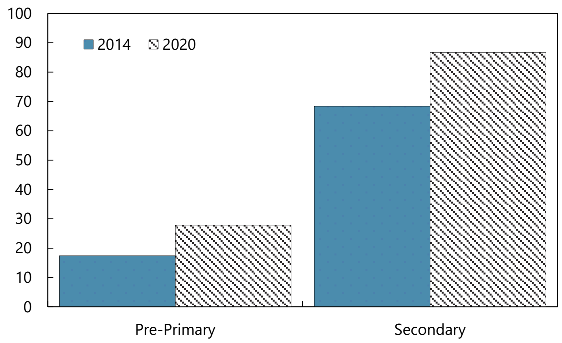


Source: Statista.

Figure 7. Timor-Leste: Labor Market Indicators

School enrollment rates in Timor-Leste increased significantly in recent years…

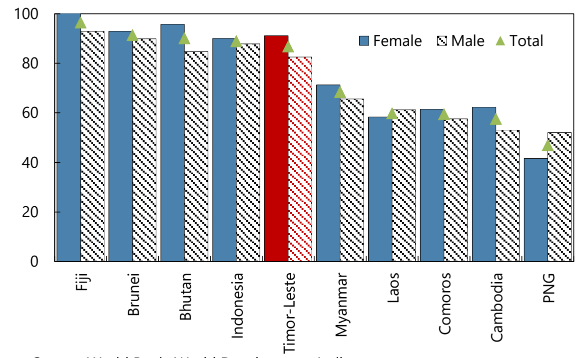
Gross School Enrollment
(Percent)



Source: World Bank, World Development Indicators.

…with secondary enrollment rate better or comparable with peers…

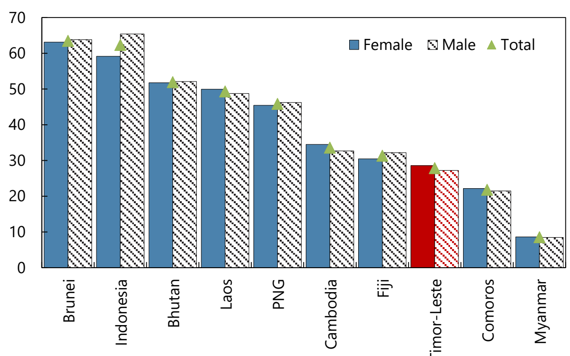
Gross School Enrollment: Secondary
(Percent, 2021 or latest available year)



Source: World Bank, World Development Indicators.

…but lagging in pre-primary enrollment.

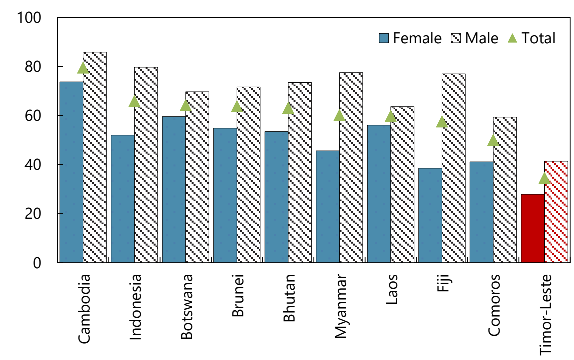
Gross School Enrollment: Pre-Primary
(Percent, 2021 or latest available year)



Source: World Bank, World Development Indicators.

Labor force participation is the lowest among peers, while the gap between women and men is similar to peers…

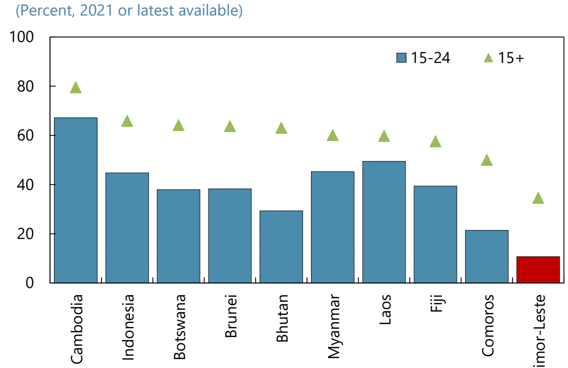
Labor Force Participation
(Percent, 15+, 2021 or latest available)



Source: ILO.

Labor force participation among youth is very low…

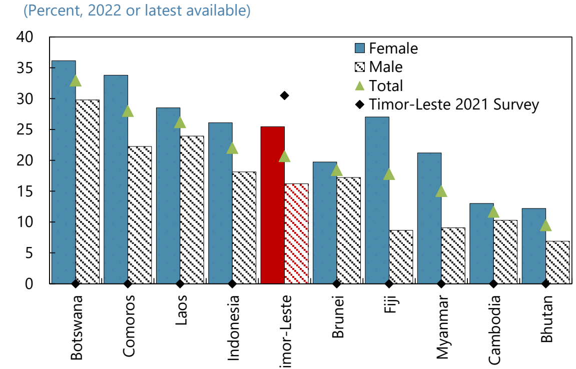
Labor Force Participation: By Age Cohorts
(Percent, 2021 or latest available)



Source: ILO.

…with a sizable share of the youth population not in education, employment, and training.

Youth Not in Education, Employment, & Training (NEET)
(Percent, 2022 or latest available)

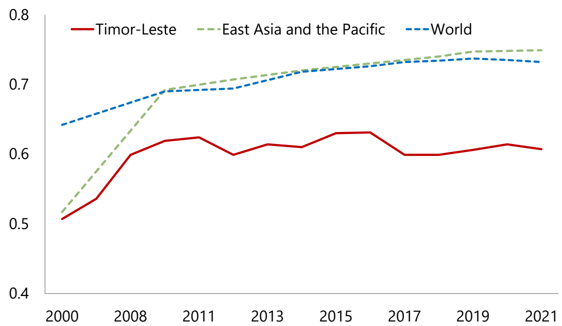


Sources: ILO; and 2021 Timor-Leste Labor Force Survey.

Figure 8. Timor-Leste: Human Capital Indicators

Timor-Leste's human development indicators had improved steadily until mid-2010s but have been stagnating recently…

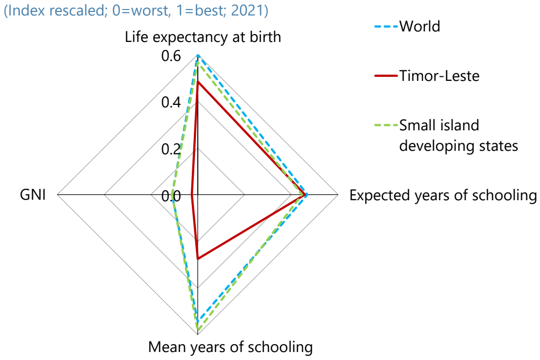
Human Development Index (HDI)
(Higher is better)



Source: United Nations Human Development Report, 2021.

…reflecting lags in average years of schooling.

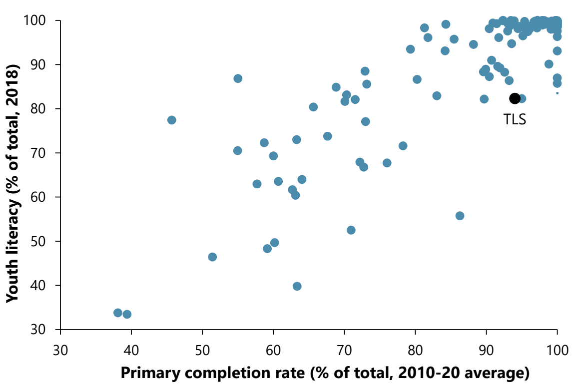
HDI Components
(Index rescaled; 0=worst, 1=best; 2021)



Source: United Nations Human Development Report, 2021.

Improved completion rates of basic education achieved in recent years will help to raise the literacy rate…

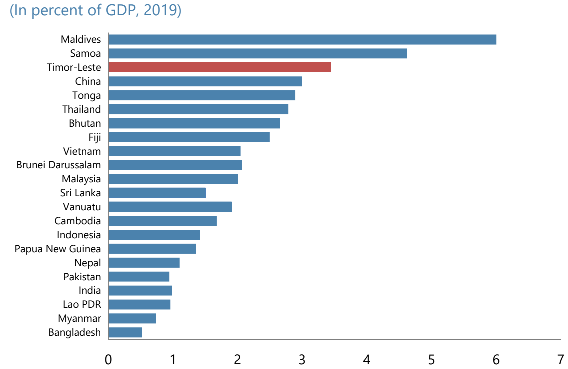
Human Capital: Youth Literacy



Source: World Bank, World Development Indicators.

…and improving the quality and efficiency of public spending on health would help strengthen human capital.

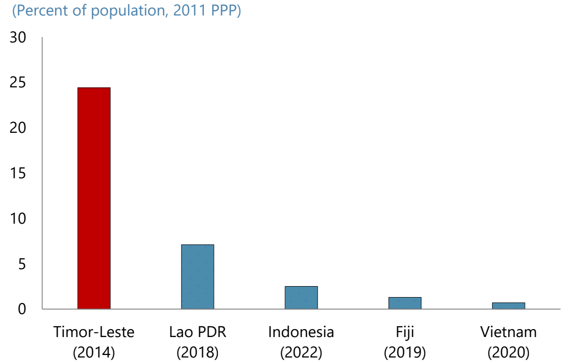
Health Expenditure: Selected Developing Asian Economies
(In percent of GDP, 2019)



Source: World Bank, World Development Indicators.

The poverty rate is among the highest in the region.

Poverty Headcount Ratio at $1.90 a Day
(Percent of population, 2011 PPP)



Source: World Bank, World Development Indicators.

The informal sector constitutes a relatively high portion of total employment, and the share is higher for less-educated groups.

Informal Sector Employment, by Education Attainment
(Share in total employment, 2021)

Sources: Timor-Leste General Directorate of Statistics and Ministry of Finance.

Table 1. Timor-Leste: Selected Economic and Financial Indicators, 2020–28

Non-oil GDP at current prices (2022): US$1.672 billion
Population (2022): 1.332 million
Non-oil GDP per capita (2022): US$1,256
Quota: SDR 25.6 million

	2020	2021	2022	2023 Est.	2024 Proj.	2025 Proj.	2026 Proj.	2027 Proj.	2028 Proj.
	(Annual percent change)								
Real sector									
Real Non-oil GDP	-7.2	1.6	4.0	1.5	3.5	3.2	3.1	3.0	3.0
CPI (annual average)	0.5	3.8	7.0	8.4	3.5	2.2	2.0	2.0	2.0
CPI (end-period)	1.2	5.3	6.9	8.7	2.5	2.0	2.0	2.0	2.0
	(In percent of Non-oil GDP, unless otherwise indicated)								
Central government operations									
Revenue	57.5	58.8	57.3	49.1	45.8	42.0	38.9	35.9	33.2
Domestic revenue	11.5	10.3	10.3	10.0	10.0	10.1	10.2	10.4	10.6
Estimated Sustainable Income (ESI)	34.4	36.9	35.7	28.6	26.4	23.5	21.1	18.8	16.6
Grants	11.6	11.6	11.4	10.5	9.4	8.4	7.6	6.7	6.0
Expenditure	83.4	104.1	115.5	90.5	88.3	85.1	82.3	79.6	77.0
Recurrent	61.7	83.5	92.0	67.9	65.0	62.6	60.5	58.5	56.6
Net acquisition of nonfinancial assets	10.1	9.0	12.1	12.1	14.0	14.1	14.2	14.4	14.5
Donor project	11.6	11.6	11.4	10.5	9.4	8.4	7.6	6.7	6.0
Net lending/borrowing	-25.8	-45.2	-58.2	-41.4	-42.6	-43.1	-43.4	-43.6	-43.8
	(Annual percent change, unless otherwise indicated)								
Money and credit									
Deposits	10.1	29.3	8.6	9.4	8.2	7.3	7.2	7.1	7.1
Credit to the private sector	10.1	4.6	34.5	19.2	7.1	6.6	6.7	6.6	6.8
Lending interest rate (percent, end of period)	11.3	11.3	11.3	11.3	11.3	11.3	11.3	11.3	11.3
	(In millions of U.S. dollars)								
Balance of payments									
Current account balance	-281	151	273	-372	-832	-930	-1,027	-1,139	-1,238
(In percent of Non-oil GDP)	-18	10	16	-20	-41.8	-43.4	-44.8	-46.4	-47.2
Trade of Goods	-607	-1,340	-1,959	-1,234	-885	-939	-995	-1,053	-1,115
Exports of goods	32	-591	-1,054	-346	73	83	95	109	125
Imports of goods	639	749	906	887	958	1,022	1,091	1,162	1,239
Trade of Services	-217	-153	-150	-154	-181	-207	-232	-257	-262
Primary Income	608	1,638	2,452	1,091	316	303	295	283	265
of which: other primary income (oil/gas) 1/	326	720	1,106	409	0	0	0	0	0
Secondary Income	-65	7	-69	-75	-81	-87	-94	-111	-127
Overall balance	-0.1	279	-102	-4	79	74	78	81	71
Public foreign assets (end-period) 2/	19,647	20,667	18,212	18,331	17,680	17,112	16,451	15,700	14,858
(In months of imports)	263	266	196	198	174	156	139	123	110
Exchange rates									
NEER (2010=100, period average)	151.2	151.0	162.9	...	...	...	...	...	...
REER (2010=100, period average)	134.0	131.0	137.9	...	...	...	...	...	...
Memorandum items									
Nominal Non-oil GDP (in millions of U.S. dollars)	1,581	1,560	1,672	1,833	1,992	2,140	2,292	2,453	2,625
Nominal Non-oil GDP per capita (in U.S. dollars)	1,226	1,190	1,256	1,357	1,454	1,540	1,627	1,718	1,814
(Annual percent change)	-7.5	-2.9	5.5	8.1	7.1	5.9	5.7	5.6	5.6
Crude oil prices (U.S. dollars per barrel, WEO) 3/	42	69	96	81	79	75	72	70	68
Petroleum Fund balance (in millions of U.S. dollars) 4/	18,991	19,732	17,379	17,503	16,772	16,130	15,391	14,560	13,646
(In percent of Non-oil GDP)	1,201	1,265	1,039	955	842	754	671	594	520
Public debt (in millions of U.S. dollars)	219	235	253	275	284	311	325	333	351
(In percent of Non-oil GDP)	13.8	15.1	15.1	15.0	14.2	14.5	14.2	13.6	13.4
Population growth (annual percent change)	1.5	1.6	1.6	1.4	1.4	1.4	1.4	1.4	1.4

Sources: Timor-Leste authorities; and IMF staff estimates and projections.

1/ Oil sector activities are considered non-resident activities in balance of payments statistics.

2/ Includes Petroleum Fund balance and the central bank's official reserves.

3/ Simple average of UK Brent, Dubai, and WTI crude oil prices based on October 2023 WEO assumptions.

4/ Closing balance.

Table 2. Timor-Leste: Summary Operations of the Central Government, 2020–28 1/

	2020	2021	2022	2023	2024	2025	2026	2027	2028
				Est.	Proj.	Proj.	Proj.	Proj.	Proj.
				(In millions of U.S. dollars)					
Revenue	**910**	**917**	**959**	**902**	**915**	**904**	**896**	**885**	**875**
Domestic revenue	182	161	172	185	202	219	237	257	280
Taxes	119	119	143	153	168	182	197	215	234
Non-tax revenue	63	42	29	31	34	36	39	41	44
Estimated Sustainable Income	544	576	596	525	525	503	484	462	437
Donor Projects	183	181	190	192	188	182	175	166	158
Expenditure	**1,318**	**1,623**	**1,931**	**1,659**	**1,760**	**1,822**	**1,887**	**1,953**	**2,023**
Expenditure excluding donor projects	1,135	1,442	1,741	1,467	1,572	1,641	1,712	1,787	1,865
Expense	1,158	1,483	1,728	1,437	1,482	1,521	1,561	1,601	1,643
Recurrent	975	1,302	1,538	1,245	1,294	1,339	1,386	1,435	1,485
Compensation of employees	202	226	257	433	436	469	485	502	520
Goods and services	378	411	397	236	256	285	296	307	315
Current transfers	387	651	867	539	553	576	596	617	638
Interest payment	2	4	9	8	9	9	9	9	12
Donor projects	183	181	190	192	188	182	175	166	158
Net acquisition of NFA	160	140	203	222	278	301	326	352	380
Gross operating balance	**-249**	**-566**	**-770**	**-535**	**-567**	**-617**	**-666**	**-715**	**-768**
Net lending/borrowing	**-409**	**-706**	**-973**	**-757**	**-845**	**-918**	**-991**	**-1,068**	**-1,148**
Statistical discrepancy	-75	-195	-340	1	1	1	1	1	0
Net financial transactions	-334	-511	-632	-759	-846	-920	-993	-1,069	-1,148
Net acquisition of FA	-308	-495	-614	-737	-837	-892	-979	-1,061	-1,129
Foreign	0	0	0	0	0	0	0	0	1
Domestic (net)	-308	-495	-614	-737	-837	-892	-979	-1,061	-1,130
Equity	-342	-573	-808	-877	-991	-892	-979	-1,061	-1,131
of which, Excess withdrawal from PF	-342	-573	-808	-877	-991	-892	-979	-1,061	-1,131
Change in cash/deposit	34	78	194	140	154	0	0	0	0
Net incurrence of liabilities	26	16	18	22	9	28	13	8	20
Foreign	30	23	31	35	25	45	32	27	35
Domestic	0	0	0	0	0	0	0	0	1
Amortization	3.9	6.4	12.5	13.4	16.2	17.3	18.5	18.7	15.9
				(in percent of nominal non-oil GDP)					
Revenue	**57.5**	**58.8**	**57.3**	**49.2**	**45.9**	**42.2**	**39.1**	**36.1**	**33.3**
Domestic revenue	11.5	10.3	10.3	10.1	10.2	10.2	10.3	10.5	10.7
Taxes	7.5	7.6	8.6	8.3	8.4	8.5	8.6	8.8	8.9
Non-tax revenue	4.0	2.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Estimated Sustainable Income	34.4	36.9	35.7	28.6	26.4	23.5	21.1	18.8	16.6
Expenditure	**83.4**	**104.1**	**115.5**	**90.5**	**88.4**	**85.2**	**82.3**	**79.6**	**77.1**
Expenditure excluding donor projects	71.8	92.4	104.1	80.0	78.9	76.7	74.7	72.8	71.0
Expense	73.2	95.1	103.4	78.4	74.4	71.1	68.1	65.3	62.6
Recurrent	61.7	83.5	92.0	67.9	65.0	62.6	60.5	58.5	56.6
Compensation of employees	12.7	14.5	15.3	23.6	21.9	21.9	21.2	20.5	19.8
Goods and services	23.9	26.3	23.7	12.9	12.8	13.3	12.9	12.5	12.0
Current transfers	24.5	41.8	51.9	29.4	27.8	26.9	26.0	25.1	24.3
Donor projects	11.6	11.6	11.4	10.5	9.4	8.5	7.6	6.8	6.0
Net acquisition of NFA	10.1	9.0	12.1	12.1	14.0	14.1	14.2	14.4	14.5
Gross operating balance	**-15.7**	**-36.3**	**-46.0**	**-29.2**	**-28.4**	**-28.8**	**-29.0**	**-29.2**	**-29.3**
Net lending/borrowing	**-25.8**	**-45.2**	**-58.2**	**-41.3**	**-42.4**	**-42.9**	**-43.2**	**-43.5**	**-43.7**
Statistical discrepancy	-4.7	-12.5	-20.4	0.1	0.1	0.1	0.1	0.1	0.0
Net financial transactions	-21.1	-32.8	-37.8	-41.4	-42.5	-43.0	-43.3	-43.6	-43.7
Net acquisition of FA	-19.5	-31.7	-36.7	-40.2	-42.0	-41.7	-42.7	-43.3	-43.0
Domestic (net)	-19.5	-31.7	-36.7	-40.2	-42.0	-41.7	-42.7	-43.3	-43.0
Equity	-21.6	-36.7	-48.3	-47.9	-49.8	-41.7	-42.7	-43.3	-43.1
of which, Excess withdrawal from PF	-21.6	-36.7	-48.3	-47.9	-49.8	-41.7	-42.7	-43.3	-43.1
Change in cash/deposit	2.1	5.0	11.6	7.6	7.7	0.0	0.0	0.0	0.0
Net incurrence of liabilities	1.7	1.0	1.1	1.2	0.4	1.3	0.6	0.3	0.7
Memorandum item									
Nominal Non-oil GDP	1,581	1,560	1,672	1,833	1,992	2,140	2,292	2,453	2,625
Petroleum Fund									
Opening balance	17,692	18,991	19,732	17,379	17,503	16,774	16,134	15,397	14,566
Comprehensive investment income	2,185	1,907	-936	1,526	788	755	726	693	654
Oil and gas receipts	326	720	1,106	409	0	0	0	0	0
Investment returns incl. valuation gain/ loss	1,859	277	307	399	438	419	403	385	364
(*Minus*) Expenses and withholding tax	0	0	0	0	0	0	0	0	1
Withdrawal	886	1,149	1,404	1,402	1,517	1,395	1,463	1,523	1,568
Estimated Sustainable Income (ESI)	544	576	596	525	525	503	484	462	437
Excess withdrawal	342	573	808	877	991	892	979	1,061	1,131
Closing balance	18,991	19,732	17,379	17,503	16,774	16,134	15,397	14,566	13,654
(In percent of non-oil GDP)	1,201	1,265	1,039	955	842	754	672	594	520

Sources: Timor-Leste authorities; IMF staff calculations.

1/This table is in accordance with the GFS format, with some modifications, to facilitate policy discussion and analysis.

Table 3. Timor-Leste: Monetary Developments, 2020–23

	2020	2021	2022	2023 Est.
Banking system 1/				
Net foreign assets 2/	**1,574**	**1,928**	**2,242**	**2,233**
Gross reserves	657	935	788	829
Other foreign assets	1,045	1,185	1,614	1,565
Foreign liabilities	127	191	160	160
Net domestic assets	**-705**	**-810**	**-1,028**	**-861**
Net credit to central government	-707	-785	-979	-979
Net credit to state and local government	-1	-9	-4	0
Net credit to public nonfinancial corporations	-51	-52	-52	0
Credit to private sector	290	304	408	487
Other items (net)	-236	-268	-402	-369
Broad money	**869**	**1,119**	**1,215**	**1,373**
Narrow money	496	619	679	767
Currency in circulation 3/	23	26	28	31
Transferable deposits	473	593	651	736
Central Bank				
Net foreign assets	**645**	**890**	**788**	**829**
Gross reserves	657	935	788	829
Foreign liabilities	11	45	0	0
Net domestic assets	**-494**	**-572**	**-615**	**-475**
Net credit to central government	-446	-443	-457	-317
Net credit to other depository corporations	86	21	46	46
Other items (net)	-135	-150	-204	-204
Monetary Base	**151**	**318**	**172**	**353**
Currency in circulation	23	26	28	31
Other liabilities to depositary corporations	128	292	145	322
Others 2/	0	0	0	0
	(12-month percentage change)			
Broad money growth	10.2	28.7	8.6	13.0
Reserve money growth	16.6	110.3	-45.7	104.8
Credit to the private sector growth	10.1	4.6	34.5	19.2
Memorandum items				
Credit/GDP	18.4	19.5	24.4	26.6
Broad money/GDP	54.9	71.7	72.7	74.9
Credit/deposits 3/	34.3	27.8	34.4	37.5
Amounts of non-perfoming loans (in millions of U.S. dollars)	9.1	6.7	6.7	8.4
Non-performing loans/total loans	3.8	2.4	2.2	2.2
Loan rate 4/	11.3	11.3	11.3	11.3
Deposit rate 5/	0.6	0.6	0.6	0.6

Sources: Central Bank of Timor-Leste; and IMF staff estimates.

1/ Includes the Central Bank, four commercial banks (including three branches of foreign banks).

2/ Includes only coinage issued by the Central Bank. No data is available for notes due to dollarization of the financial system.

3/ Excludes government deposits.

4/ Rate charged by other depository corporations on loans in U.S. dollars. The rate is weighted by loan amounts.

5/ Rate offered by other depository corporations on three-month time deposits in U.S. dollars. The rate is weighted by deposit amounts.

Table 4. Timor-Leste: Balance of Payments, 2020–28 1/

	2020	2021	2022	2023	2024	2025	2026	2027	2028
				Est.	Proj.	Proj.	Proj.	Proj.	Proj.
(In millions of U.S. dollars)									
Current account balance	-281	151	273	-372	-832	-930	-1,027	-1,139	-1,238
Trade of Goods	-607	-621	-853	-825	-885	-939	-995	-1,053	-1,115
Exports of goods	32	129	53	63	73	83	95	109	125
of which: Coffee	12	28	26	31	36	42	48	55	62
Imports of goods	-639	-749	-906	-887	-958	-1,022	-1,091	-1,162	-1,239
Trade of Services	-217	-153	-150	-154	-181	-207	-232	-257	-262
Receipts	40	28	60	69	77	86	97	109	123
of which: Travel	26	12	43	49	55	62	70	80	91
Payments	-256	-182	-211	-223	-258	-293	-329	-366	-385
Primary Income	608	919	1,345	683	316	303	295	283	265
of which: Investment income	278	195	235	270	311	299	290	278	260
of which: Other primary income (oil/gas) 1/	326	720	1,106	409	0	0	0	0	0
Secondary Income	-65	7	-69	-75	-81	-87	-94	-111	-127
of which: Remittance inflows	123	171	183	200	217	232	249	267	286
Capital and financial accounts	-422	-258	-150	367	911	1,004	1,104	1,220	1,309
Official capital transfers	12	13	17	24	18	17	18	19	19
Financial account	-434	-271	-166	343	893	987	1,087	1,202	1,290
Direct investment	-650	-69	-29	-30	-31	-32	-32	-33	-34
Portfolio investment	272	-150	152	765	1,281	1,357	1,471	1,591	1,669
Other investment	-57	-52	-289	-388	-357	-338	-352	-356	-344
Assets	-57	-96	-366	-366	-366	-366	-365	-364	-363
Liabilities	0	44	77	22	9	28	13	8	19
Government Debt	-4	36	64	22	9	28	13	8	19
Errors and omissions (net)	702	385	-225	0	0	0	0	0	0
Overall balance	-0.1	279	-102	-4	79	74	78	81	71
Financing									
Change in net foreign assets (banking sector)	0.1	-279	102	4	-79	-74	-78	-81	-71
(In percent of Non-oil GDP)									
Current account balance	-17.7	9.7	16.3	-20.3	-41.8	-43.4	-44.8	-46.4	-47.2
Trade of Goods	-38.4	-39.8	-51.0	-45.0	-44.4	-43.9	-43.4	-42.9	-42.5
Exports of goods	2.0	8.2	3.1	3.4	3.7	3.9	4.2	4.4	4.7
Imports of goods	-40.4	-48.0	-54.2	-48.4	-48.1	-47.8	-47.6	-47.4	-47.2
Trade of Services	-13.7	-9.8	-9.0	-8.4	-9.1	-9.7	-10.1	-10.5	-10.0
Primary Income	38.5	58.9	80.5	37.2	15.8	14.2	12.8	11.5	10.1
Secondary Income	-4.1	0.4	-4.1	-4.1	-4.1	-4.1	-4.1	-4.5	-4.8
Capital and financial accounts	-26.7	-16.6	-8.9	20.0	45.7	46.9	48.2	49.7	49.9
Overall balance	-0.01	17.9	-6.1	-0.2	4.0	3.5	3.4	3.3	2.7
(In millions of U.S. dollars, unless otherwise indicated)									
Memorandum items:									
Public foreign assets (end-period)	19,647	20,667	18,212	18,331	17,680	17,112	16,451	15,700	14,858
(In months of imports of G&S)	263	266	196	198	174	156	139	123	110
(In percent of Non-oil GDP)	1,242	1,325	1,089	1,000	888	800	718	640	566
of which: Central bank reserves	656	935	833	829	908	982	1,059	1,141	1,212
Petroleum Fund balance 2/	18,991	19,732	17,379	17,503	16,772	16,130	15,391	14,560	13,646
(In percent of Non-oil GDP)	1,201	1,265	1,039	955	842	754	671	594	520
NIIP	18,834	19,816	18,404	18,729	18,331	17,884	17,390	16,836	16,123
(In percent of Non-oil GDP)	1,191	1,271	1,101	1,022	920	836	759	686	614
Nominal Non-oil GDP	1,581	1,560	1,672	1,833	1,992	2,140	2,292	2,453	2,625
Nominal Total GDP	2,163	3,622	3,205	2,333	1,992	2,140	2,292	2,453	2,625

Sources: Data provided by the Timor-Leste authorities; and IMF staff estimates.

1/ Oil sector activities are considered non-resident activities in balance of payments statistics.
2/ Closing balance.

Table 5. Timor-Leste: Sustainable Development Goals Monitoring

Goals	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Poverty										
Income share held by lowest 20%		9.4								
Poverty gap at $1.90 a day (2011 PPP) (%)		5.1								
Poverty headcount ratio at $1.90 a day (2011 PPP) (% of population)		24.4								
Poverty headcount ratio at national poverty lines (% of population)		41.8								
Hunger										
Prevalence of overweight (modeled estimate, % of children under 5)	2.2	2.1	1.9	1.8	1.7	1.6	1.5	1.4	1.3	1.3
Prevalence of stunting, height for age (modeled estimate, % of children under 5)	51.5	50.6	49.7	48.8	48.1	47.4	46.7	46.1	45.6	45.1
Prevalence of undernourishment (% of population)	29.8	28.4	27.6	27.1	26.1	25.0	23.8	23.7	22.3	
Prevalence of underweight, weight for age (% of children under 5)	37.5	32.4						31.9		
Prevalence of wasting, weight for height (% of children under 5)	9.9	12.2						8.3		
Good Health and Well-being										
Births attended by skilled health staff (% of total)				56.7						
Mortality rate, under-5 (per 1,000 live births)	65.3	63.5	61.6	59.7	57.7	55.8	53.9	52.2	50.5	
Mortality rate, neonatal (per 1,000 live births)	25.9	25.4	25.0	24.5	24.1	23.6	23.2	22.8	22.2	
Demand for family planning satisfied by modern methods (% of married women with demand for family planning)				46.9						
Adolescent fertility rate (births per 1,000 women ages 15-19)	41.6	40.0	38.4	37.2	36.5	35.7	35.2	34.6	33.9	
Smoking prevalence, males (% of adults)			72.3			69.1	68.4	67.6		
Source data assessment of statistical capacity (scale 0 - 100)	70.0	60.0	60.0	70.0	70.0	60.0	60.0	60.0		
Gender Equity										
Proportion of women subjected to physical and/or sexual violence in the last 12 months (% of women age 15-49)				34.6						
Women who were first married by age 15 (% of women ages 20-24)				2.6						
Women who were first married by age 18 (% of women ages 20-24)				14.9						
Adolescent fertility rate (births per 1,000 women ages 15-19)	41.6	40.0	38.4	37.2	36.5	35.7	35.2	34.6	33.9	
Clean Water and Sanitation										
People using at least basic drinking water services (% of population)	70.0	72.1	74.2	76.4	78.6	80.8	82.4	84.0	85.6	87.0
People using at least basic sanitation services (% of population)	48.5	49.7	50.8	51.9	53.0	54.1	55.2	56.3	57.3	58.4
Affortable and Clean Energy										
Access to electricity (% of population)	59.2	62.4	67.3	76.5	79.5	85.2	90.6	96.0	100.0	
Access to clean fuels and technologies for cooking (% of population)	6.8	7.7	8.6	9.5	10.7	11.7	12.9	14.0	15.2	
Decent Work and Economic Growth 1/										
Unemployment rate (% of total labor force)	4.0	4.2	4.5	4.7	4.6	4.5	4.4	5.1	-	-
Peace, Justice and Strong Institutions 1/										
Corruption Perception Index (worst 0-100 best)	30	28	28	35	38	35	38	40	-	-
Global Partnerships for the Sustainable Development										
Individuals using the Internet (% of population)	11.0	17.5	18.6	21.2	24.2	27.6	28.0	34.1	39.5	

Source: World Bank's World Development Indicators

1/ Source: Sachs, J., Kroll, C., Lafortune, G., Fuller, G., Woelm, F. (2021). The Decade of Action for the Sustainable Development Goals: Sustainable Development Report 2021. Cambridge: Cambridge University Press.

Annex I. Country Engagement Strategy[1]

A. Background and Context

1. **Notwithstanding impressive progress since independence, Timor-Leste remains a fragile post-conflict nation**. Timor-Leste is a lower middle-income country (GNI per capita in 2022: $1,970) with presumed blender status for General Resources Account (GRA) and Poverty Reduction and Growth Trust (PRGT) resources. A Small Development State (SDS) with a population of 1.3 million, Timor-Leste has achieved significant growth since its independence in 2002. However, 48 percent of the population remains multidimensionally poor based on the UNDP's Global Multidimensional Poverty Index. Since it became an IMF member in July 2002, the IMF has supported Timor-Leste's development through surveillance and technical assistance.

2. **Over the past 20 years, Timor-Leste has accumulated substantial savings from its oil production.** The Petroleum Fund law was passed in 2004, stipulating that all oil and gas revenues flow directly into a savings fund that can only be used for budget financing. The Petroleum Fund (PF) had a balance of 1,043 percent of non-oil GDP as of end-2022, making Timor-Leste the PRGT-eligible country with the largest Net Foreign Asset position as a share of the domestic economy. These resources provide a buffer against shocks and a large endowment to finance the country's urgent development needs. Staff estimate the fund generates about 29 percent of GDP in sustainable income, but withdrawals to finance the large fiscal deficits have far exceeded this amount in recent years, such that the PF is being depleted over time.

B. Drivers of fragility

3. **Timor-Leste has a set of fragility drivers stemming from its history and geography.** Political instability and a lack of the rule of law hinder private sector development. This challenge is exacerbated by heavy reliance on the oil sector, with limited economic diversification and low non-oil fiscal revenue. Moreover, vulnerability to climate change heightens the risk to sustainable growth.

- **Political instability.** The short period that has passed following decades of conflict is considered the root cause of political instability in Timor-Leste. Additionally, the civil unrest and political turmoil in 2006 has created a scarring effect on its fragility in the subsequent years. Political instability has frequently been a drag for economic growth, including by causing significant delays of budget approvals, as witnessed after the election in 2017. The persistent political instability has significantly constrained government capacity, hampering the continuity of policies that is essential for executing long-term structural reforms. The unstable institutional environment has also hindered domestic private investments and inward foreign direct investments. Timor-Leste

[1] This Country Engagement Strategy provides an overview of the drivers of fragility, constraints to reform, and reform priorities that inform the strategy for Fund engagement with Timor-Leste. The strategy draws insights from exchanges with the authorities (Ministry of Finance, Central Bank, Ministry of Petroleum and Minerals, Secretary of State for Training and Employment, Business Registration and Verification Service, and Anti-Corruption Commission), development partners (World Bank, IFC, ADB, UN agencies, Australia, Japan, and the United States), and the private sector (private banks, corporates, and academia).

ranks among the lowest in the Asia-Pacific region in the Worldwide Governance Indicators in this area.

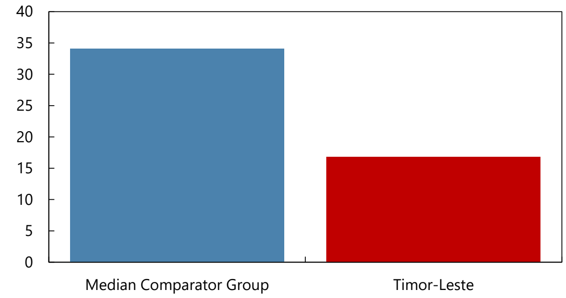
- **Lack of governance and rule of law.** Poor governance and corruption, weakness in the rule of law and the justice sector, and lack of clarity over land management and ownership underpin Timor-Leste's fragility (World Bank 2019). Specifically, Timor-Leste's legal framework remains underdeveloped in licensing requirements, property rights, contract enforcement, and insolvency frameworks. Additionally, continued efforts are needed to develop the justice system, including by training more lawyers and judges. There is a clear need to establish a rules-based culture, robust safeguards, and clear accountability. Timor-Leste ranks among the lowest in the Asia-Pacific region in the Worldwide Governance Indicators in this area.

- **Limited economic diversification.** Offshore oil and gas production has been a large part of Timor-Leste's economy. While this sector has driven the remarkable growth since its independence, heavy dependence on this sector has left the economy underdeveloped and undiversified. The scale of product and labor markets is small as an SDS. Over 60 percent of the workforce is still employed in agriculture, with many limited to subsistence farming. Oil-derived financing of the budget and limited activity in other sectors have limited mobilization of domestic tax revenue, which only covered about 9 percent of public expenditure in 2022. A lack of domestic production leaves domestic consumption mainly supplied through imports, while exports are extremely limited, giving rise to a sizable external imbalance. With active oil fields now depleted and the PF projected to be exhausted by the end of the 2030s, private sector growth and diversification are an urgent development priority.

- **Natural disaster and climate change risks.** Timor-Leste's vulnerability to climate change and natural disasters is among the highest across Asian economies. The country is vulnerable to natural disasters, with 14 having hit the economy since 2001 (see the 2022 Article IV Selected Issues). Concerningly, public expenditure on climate-related initiatives has been declining in recent years. The IMF's Climate-driven INFORM Risk Indicator suggests that Timor-Leste faces higher climate-driven hazards than peer economies.

Private sector development has been hindered by political instability…

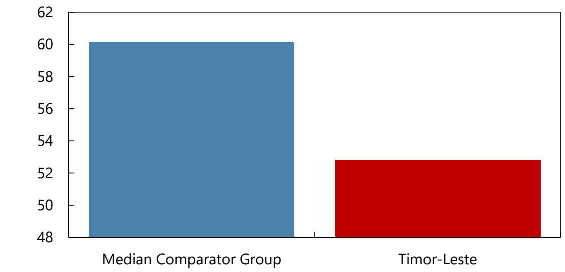
The Worldwide Governance Indicators: Rule of Law[1]
(Ranking in percentile; 2021)



Source: Daniel Kaufmann and Aart Kraay (2023).
1/ Comparator Group: Cambodia, Fiji, Maldives, Myanmar, Lao PDR, PNG, Solomon Island, Vanuatu.

…and a lack of governance and rule of law….

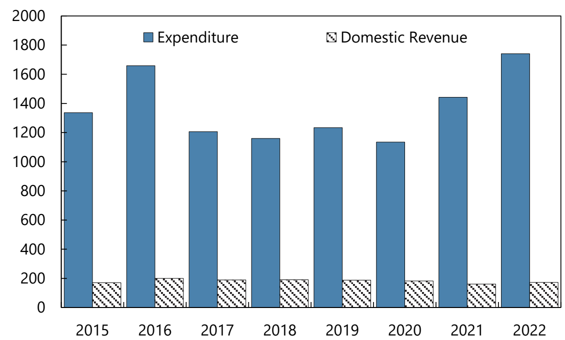
The Worldwide Governance Indicators: Political Stability and Absence of Violence/Terrorism[1]
(Ranking in percentile; 2021)



Source: Daniel Kaufmann and Aart Kraay (2023).
1/ Comparator Group: Cambodia, Fiji, Maldives, Myanmar, Lao PDR, PNG, Solomon Island, Vanuatu.

…resulting in a vicious cycle of limited economic diversification and heavy reliance on the oil/gas sector.

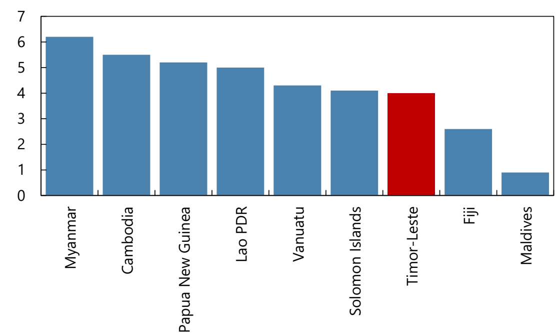
Expenditure and Domestic Revenue
(In millions of US dollars)



Source: Timor-Leste Ministry of Finance.

Vulnerability to climate change further threatens their sustainable growth.

Climate-driven INFORM Risk Indicator
(2022)



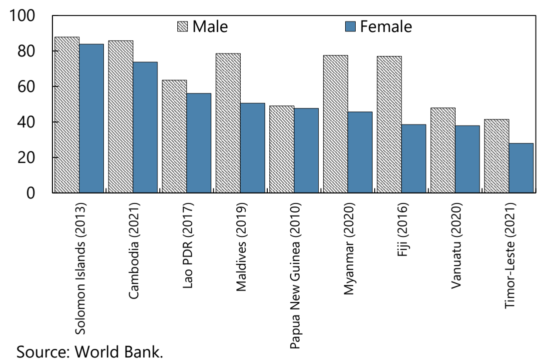
Source: IMF (Climate Change Dashboard).

4. These factors result in three major economic challenges that exacerbate the fragility of Timor-Leste:

- **Large fiscal and external imbalances.** Without major expenditure and revenue reforms, the fiscal deficit is projected to remain above 40 percent of non-oil GDP for the next decade. Public expenditure of around 100 percent of non-oil GDP largely made up of transfers boosts imports and contributes to a large external imbalance, with the current account deficit expected to approach 50 percent of non-oil GDP in 2033. While the risk of debt distress is assessed as moderate, long-term risks are underscored by large fiscal deficits financed by withdrawals from the PF that far exceed its investment income. The depletion of the PF could lead to a fiscal cliff by the end of the 2030s, necessitating an abrupt spending cut that would result in a sudden halt of essential imports and public services.

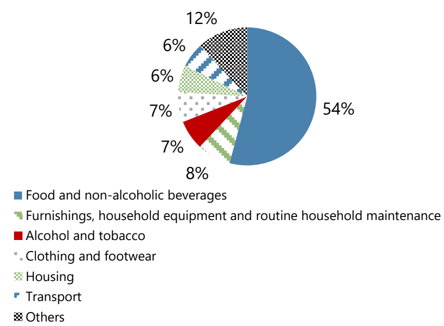
- **Utilization of the demographic and gender dividend.** The younger generation faces significant challenges in terms of employment and education. The percentage of individuals aged 15-24 who are not in employment, education, or training (NEET) amounted to 31 percent in 2021, well above the Asia-Pacific regional average of 23 percent. Also, women seem to face greater challenges than men, with an even lower labor force participation rate. These issues are closely linked with underinvestment in human capital development. In education, the enrollment rates in early childhood and secondary education are still low, particularly in remote regions. The quality of teaching and educational facilities is poor, resulting in high grade repetition and school dropouts (World Bank 2021). The World Bank’s Human Capital Index scores Timor-Leste at 0.45, which is lower than the East Asia and Pacific average of 0.6.

Labor Force Participation Rate, by Gender
(Percentage)



Source: World Bank.

CPI Basket Weights
(Percent of basket)



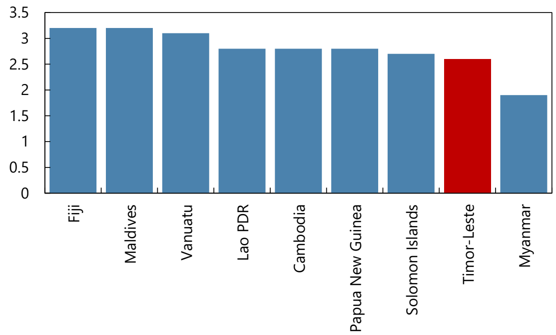
Source: Timor-Leste General Directorate of Statistics.

- **Low agricultural productivity and food insecurity.** The declining productivity in the agricultural sector has been undermining food security in Timor-Leste. The agriculture value added per worker dropped by 21 percent from 2010 to 2021 (World Bank 2023). Against this background, 22 percent of the population in the economy currently faces high levels of acute food insecurity (IPC 2023). In addition, insufficient food production can lead to price instability of Timor-Leste, given that food accounts for 54 percent of the consumer price index. These risks are further aggravated by vulnerability to climate change and a heavy reliance on food imports.

C. Constraints to Reform and Policies to Address the Sources of Fragility

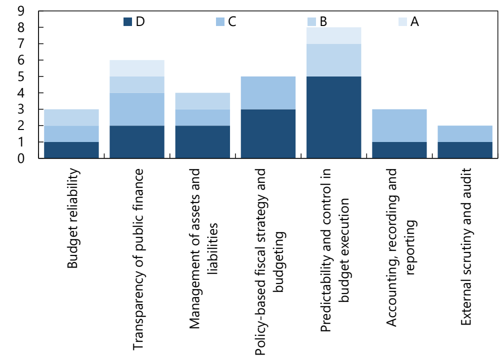
5. **The capacity of public sector management poses a significant constraint in Timor-Leste**. According to the World Bank's Country Policy and Institutional Assessment, Timor-Leste ranks as one of the lowest among Asia-Pacific peers. Specifically, the latest Public Expenditure and Financial Accountability performance assessment (PEFA 2020) suggests that the Ministry of Finance lacks (i) the capability for policy-based fiscal strategy and budgeting and (ii) predictability and control in budget execution, with more than 60 percent of the indicators in these areas showing performance below the required standards (scored as "D”). The limited budget capacity is fueled by fragmented responsibilities across ministries and other public enterprises, which also holds back progress in structural reforms. More importantly, the limited capacity creates negative feedback loops with the fragility drivers. Political instability could lead to delay in budget execution or failure in policy implimentation, which undermines the capability of the authorities. This, in turn, leads to drags on growth and creates the source of political instability.

CPIA: Public Sector Management and Institutions
(Cluster average (1=low to 6=high); 2022)



Source: World Bank.

The PEFA Performance Assessment
(The number of assessment of indicator scaling from A to D; 2018)



Source: World Bank.

D. Macroeconomic Policies to Address Fragility

6. Macroeconomic policies tailored to Timor-Leste's situation will mitigate fragility drivers and contribute to sustainable growth. Key policies include:

- **Enhancing fiscal sustainability.** This top macroeconomic priority requires immediate policy actions. First, a well-defined medium-term fiscal framework should form the foundation of a robust fiscal strategy. Second, expenditure should be rationalized and enhance its composition, focusing more on capital spending. Third, tax administration should be enhanced based on a modernized framework. Lastly, revenue mobilization should seek to raise non-oil domestic revenue to align with peers in the medium to long term.

- **Improving human capital.** This initiative requires well-targeted investment for education, particularly at the early childhood stage, to facilitate school construction and teacher hiring. Also, vocational training should be enhanced, with higher focus on the young generation and women, to enhance the demographic and gender dividend in the labor market. On the health sector, higher investment is needed to support effective delivery of routine health services, as well as building resilience to respond to health emergencies (World Bank 2019). Innovative solutions such as telemedicine can help to fill shortcomings in delivery, particularly in rural areas (see World Bank 2023).

- **Promoting private sector development.** This requires progress in a wide range of structural reforms. While some key policies (a, b, and c) call for immediate action, others (d and e) are geared toward achieving medium-term goals:

    a. Establishing a robust governance and sound business environment to foster private investments by addressing legal constraints including: (i) incomplete licensing requirements; (ii) poorly defined property rights, including due to lack of a land registry; (iii) costly contract enforcements; and (iv) lack of an insolvency framework.

b. Strengthening the tourism industry by expanding necessary infrastructure (e.g., roads and airports), attracting foreign investors, and facilitating international coordination with peer economies to invite foreign tourists.

c. Increasing productivity in the agricultural sector by assisting larger-scale coffee production and the shift to higher-value commodities.

d. Broadening access to formal credit by removing impediments to financing private sector development, including: (i) an absence of requirements for companies to prepare financial statements under a common accounting standard, and (ii) a complex and incomplete patchwork of banking regulations.

e. Fostering digitalization of government services and the banking/payment system to enhance financial development and inclusion.

- **Enhancing resilience to natural disasters and climate change**. The effort should start by improving budget planning based on realistic cost estimation. Over the medium term, grants or concessional borrowing should be pursued more to strengthen climate-adaptive capacity, given the narrowing fiscal space.

E. Fund Engagement in Capacity Development Priorities

7. Recent Fund engagement with Timor-Leste has focused on surveillance and capacity development (CD). The Fund has provided policy recommendations through annual Article IV consultations accompanied by regular staff visits. Timor-Leste is one of the largest recipients of the Fund's CD in the region. Currently 12 projects are in progress for FY2024, with most provided through the Pacific Financial Technical Assistance Centre (PFTAC) in Fiji. The country has not undertaken a Fund-supported program since its independence.

8. The Fund's CD has been driven by the authorities' requests and is well aligned with priorities identified through the surveillance process. Recent activities include the following:

- **Public Financial Management (PFM):** While PFM projects in Timor-Leste initially focused on establishing operational fiscal authorities after decades of conflict, recent progress in this area has prompted a shift towards areas such as expenditure management, treasury operations, and fiscal reporting. In 2016, the Fund cunducted a Public Investment Management Assessment (PIMA), providing policy recommendations to improve capital spending efficiency. In April 2022, a Fund mission assisted the authorities to better sequence and prioritize PFM reforms, which led to their new PFM Reform Strategy 2022-2027 and the enactment of a new comprehensive public finance law. PFTAC has been working on CD for top-down budgeting in this area.

- **Revenue administration and mobilization:** On revenue administration, PFTAC has been supporting the tax authority with strengthening control of and improving effectiveness in taxpayer registration, tax segmentation, and development of a taxpayer services strategy. On revenue mobilization, a diagnostic review of tax mobilization and administration was conducted in November 2021, and PFTAC is following up on this with expert assistance.

- **Macro statistics:** PFTAC has reviewed the methodology and the compilation system of national accounts in collaboration with the Australian statistical authorities. On GFS, recent missions have assisted the authorities in compiling annual GFS data for FY2020-2021 and to identify discrepancies with MFS. On Balance of Payments Statistics (BOPS), the Fund has assisted the authorities to improve compliance with BPM6, including in their presentation of offshore oil and gas production.

- **Debt management:** The Ministry of Finance is taking steps to formalize and develop debt management functions, yet the operational framework remains fragmented in terms the governance and organizational arrangements across government agencies. PFTAC currently supports CD to strengthen debt management capacity.

- **Macro-financial forecasting:** ICD currently supports the authorities' capacity to fully operationalize the macroeconomic framework in policy making. In February 2023, the first phase to introduce the basic accounting-based Macroeconomic Projection Tool (MPT) was completed, and the second phase started in June 2023 to help the authorities use the MPT for their budget process.

- **AML/CFT:** LEG carried out CD on the AML/CFT during 2021-2023. A proposed review of the AML/CFT framework was unable to be completed. The last mission in April 2023 supported the financial intelligence unit to strengthen its capacity for AML/CFT investigations and international cooperation.

9. Experience in delivering CD in Timor-Leste provides useful lessons for our engagement with other economies:

- Long-term resident advisors were instrumental in setting up fundamental fiscal reforms, such as the Petroleum Fund law.

- Very low absorption capacity may lead to CD substituting for local resources in the short term. In such circumstances, CD should focus more on the daily management of PFM functions than on reform or capacity building. This approach helped Timor-Leste during its transition to independence in 2002 and in addressing a significant political crisis in 2006. However, it should be noted that efforts to improve the authorities' capabilities are necessary in parallel to maintain their ownership.

- In the medium to long term, CD focus should move toward strategic planning and prioritization. In this context, engaging with the authorities to formulate a medium-term CD strategy is key to pin down the sequence and priority of necessary reforms, as was done in April 2022 for Timor-Leste.

10. CD priorities should remain focused on areas where the Fund can leverage its expertise to help reduce fragility and alleviate constraints in the economy. The focus should be on the following categories. Immediate priorities include efforts that support the development of a medium-term fiscal framework and that mobilize domestic revenue, such as PFM reform and the adoption of a Fiscal Responsibility Law and implementing the VAT.

- **A well-defined fiscal framework should be established to form the foundation of a robust fiscal strategy.** This is expected to strengthen the effectiveness and efficiency of fiscal policy both on expenditure and revenue sides. The near-term priority within this agenda is to support the adoption of a Fiscal Responsibility Law, which requires the authorities to commit to a monitorable fiscal policy objective and to lay out a strategy to achieve objectives with some flexibility. The fiscal framework should be also underpinned by effective expenditure ceilings, better prioritization based on realistic cost-benefit analysis of possible projects, and a credible budget baseline. These will help the authorities reduce excess withdrawals from the PF.

- **There is room for improving the quality of expenditure to address the fragility drivers**. Starting with the near term, the authorities need to limit recurrent expenditures on wages, goods and services, and transfers while prioritizing spending on human capital (health and education) and physical capital. More-disciplined budget planning is necessary to foster these efforts, and the Fund should support them through CD on PFM reforms, including to: strengthen top-down budgeting to improve budget credibility; upgrade the framework used for public investment management to better select projects based on the 2016 PIMA; and establish strong governance safeguards and transparent fiscal reporting. On specific spending items, employment spending can be rationalized given the high wage bill (17 percent of GDP) and expenses of temporary contracts. CD on employment policies to enhance human resource planning can support this initiative. Over the medium term, digitalization of the government will also facilitate the efficiency and equity of expenditure.

- **Revenue mobilization is a long-standing issue, but requires progress even in the near term.** The Fund has supported the authorities' effort to introduce a VAT for years, including peer-reviewing their draft law in 2016. The new government has expressed its plan to implement a VAT, which is a welcome development. However, there is still no clear timeframe for its adoption, suggesting the need to work closely with the authorities toward its implementation. The introduction of VAT is an immediate priority, and the Fund can assist the authorities by providing technical assistance primarily on institutional setting, legal drafting, and tax design/modeling. Sharing experiences of Asian peers will also help to anticipate relevant challenges. Over the medium to long term, a wide range of tax policies can be developed through CD, including property taxation, digital services taxation, environmental taxation, international tax issues, fiscal incentives, and tax system progressivity.

- **Revenue administration should play a key role in the near term to enhance fiscal sustainability**. The Fund should continue to support the tax authority to improve the efficiency and effectiveness of tax registration, filing, collections, and enforcement. More specifically, efforts are needed to: (i) modernize operations by upgrading human capacity and minimizing manual procedures in the tax administration system; (ii) develop a medium-term tax administration plan; (iii) implement institutional reforms to streamline the organizational structure of the tax authority; and (iv) upgrade the tax procedure code. Digitalization will also expedite these efforts, including through enforcement of e-tax filing.

- **Debt management will be increasingly critical over the medium to long term.** With public debt expected to rise due to the cessation of oil production, there will be a growing need for enhanced capabilities in debt reporting and monitoring, including the regular publication of debt statistics. Financial sector development should accompany these initiatives to ensure that deficit financing becomes more market-oriented and based on issuance of government securities.

- **Sustainable Development Goals (SDGs) should be pursued with better costing.** While there has been progress toward the Sustainable Development Goals, work remains including in poverty, gender, and education. Providing CD on costing SDGs could help inform the authorities and development partners about the resources required to achieve the SDGs within the context of long-term fiscal sustainability.

- **Quality and frequency in macroeconomic statistics should be urgently enhanced.** Active engagement with the authorities should be continued to improve the quality and frequency of national accounts, as well as key standard statistics such as GFS, BOPS, MFS, and FSI. These efforts will enhance the Fund's ability to engage more effectively and efficiently in CD and surveillance activities in Timor-Leste.

- **Forecasting tools should be put into operation**. The macro-financial forecasting capabilities, which forms a foundation for macroeconomic policymaking, should be fully operationalized and institutionalized. This will improve the quality of fiscal policy decisions and reduce the inefficiency of budget planning and execution. The Fund should ensure effective coordination among fiscal, monetary, and statistical authorities when providing technical assistance.

- **Governance and transparency remain important to address fragility.** Efforts should be continued to strengthen the legal and institutional frameworks for auditing and to address AML/CFT deficiencies to ensure the AML/CFT framework complies with the FATF standards.

11. Close coordination with development partners is essential to fully leverage the Fund's mandate and expertise. Conventional donors such as the World Bank, the Asian Development Bank (ADB), United Nations agencies, the European Union, and bilateral partners provide development assistance in Timor-Leste. Although the Fund maintains active engagement with these development partners, there is room to explore further role-sharing and synergies. This includes collaboration with the World Bank on a wide range of policies on PFM and structural reforms; with the IFC on financial deepening and inclusion; with the ADB on public investment management and revenue administration; and with the United Nations on digital finance, gender, and AML/CFT efforts.

12. Close coordination with development partners would help internal coordination across government ministries and agencies. Currently, fragmented coordination both among ministries and development partners obscures the overall assistance landscape. In some cases, the authorities requested identical support from different organizations, and both sides were unaware of the duplication. While it is essential for the authorities (particularly the MOF) to strengthen internal coordination to manage the size and number of aid projects within their remit, this would be facilitated by better coordinated engagement among development partners. This will also preemptively prevent overloading the authorities, which is essential for prioritizing urgent economic issues and for increasing the authorities' ownership of reforms and core functions.

13. Close coordination across departments within the Fund is also essential. Timor-Leste requires a wide range of technical assistance. This means that each project team should closely coordinate with the area department team and each other regarding the timing and sequencing of activities, to maximize the impact of Fund support and avoid overloading the authorities. Given the country's location, regional offices should remain instrumental in ensuring timely delivery and efficient communication with the authorities. While PFTAC currently has a major role in delivering CD to Timor-Leste, its remoteness means that high flight costs and long travel times act as impediments to more regular delivery. In scaling up CD efforts over time, more accessible regional offices such as the Capacity Development Office in Thailand (CDOT) could become more involved in planning/delivering training and on-the-ground CD in Timor-Leste, as is currently done in the area of PFM.

14. The achievement and sustainability of IMF engagement with Timor-Leste are subject to risks. Political instability could flare up, which could lead to substantial delays or the suspension of necessary policy initiatives. Additionally, a faster-than-expected depletion of the PF— triggered either by fiscal policy decisions or by external shocks to financing conditions and commodity prices—would raise the urgency of avoiding the fiscal cliff and may require a more abrupt adjustment, hindering needed investment in human and physical capital. Accelerated climate change could exacerbate the impact of natural disasters, including in the Dili urban area, which is situated only a few meters above sea level.

Annex II. External Sector Assessment

Overall Assessment: *On a preliminary basis and based on staff estimates, the external position in 2023 is assessed as substantially weaker than the level implied by fundamentals and desirable policies. This weak external sector position reflects large fiscal imbalances and the underdevelopment of the non-oil economy associated with the high degree of real exchange rate overvaluation.*

Potential Policy Responses: *Fiscal consolidation and structural reforms to promote private sector development and the diversification of the economy should help improve competitiveness and reduce the current account gap.*

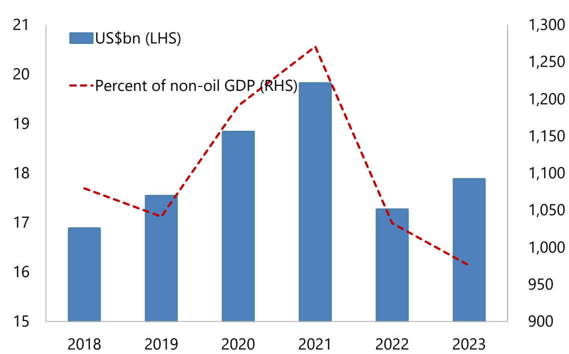
Foreign Assets and Liabilities: Position and Trajectory

Background. The net international investment position was $17.9 billion (975 percent of non-oil GDP) by Q3-2023, $0.3 billion higher than by end-2022 (but 57 percentage points of non-oil GDP lower, due to the higher GDP growth).[1] External assets and liabilities were $19.4 billion (1,058 percent of non-oil GDP) and $1.5 billion (83 percent of non-oil GDP), respectively. External assets mainly consist of portfolio investment of $17.1 billion (932 percent of non-oil GDP) and direct investment of $0.01 billion (0.35 percent of non-oil GDP) held by the Petroleum Fund, but they also include bank holdings of currency and deposits of $1.3 billion (71 percent of non-oil GDP) and foreign reserves held by the central bank of $0.8 billion (46 percent of non-oil GDP). Foreign direct investment liabilities were $1.0 billion (52 percent of non-oil GDP), loans were $0.34 billion (19 percent of non-oil GDP), and other liabilities (12 percent of non-oil GDP). About 29 percent of the financial market investment of the Petroleum Fund assets are in stocks, 56 percent in bonds, and 15 percent in U.S. dollar cash. The net international investment position increased by $1.0 billion during 2018-23, explained by $1.2 billion outflows from the financial account and $2.2 billion from valuation effects.

Assessment. With no more inflows expected from oil revenues starting in 2024, the large and persistent current account deficits under current policies are projected to steadily erode the net international investment position in the medium term.

End-September 2023 (% GDP)	**NIIP: 975**	**Gross Assets: 1058**	**Debt Assets: 616**	**Gross Liab.: 83**	**Debt Liab.: 14**

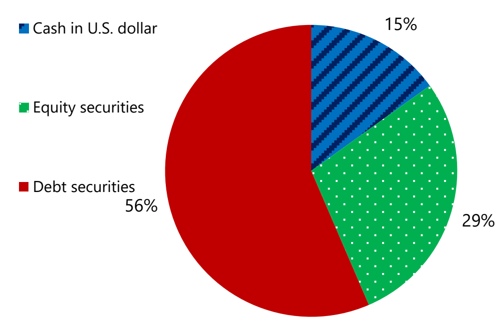
Net International Investment Position



Source: Central Bank of Timor-Leste. Q3 outturn for 2023.

Petroleum Fund Asset Composition

(Q3-2023; percent of total assets in financial market)

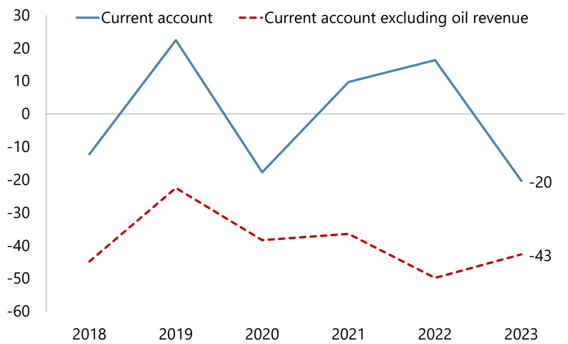


Source: Central Bank of Timor-Leste.

Current Account

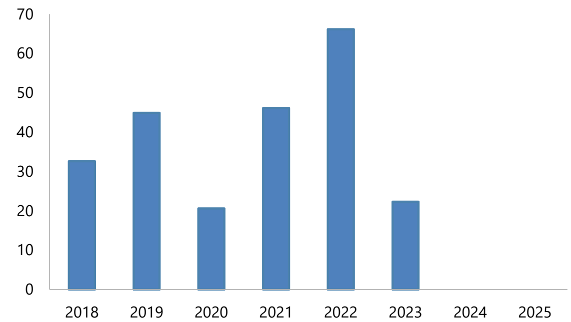
Background. The current account balance[2] deteriorated from 16 percent of non-oil GDP in 2022 to -20 percent in 2023, driven by a sharp decline in oil revenues. In contrast, the current account balance excluding oil revenues improved modestly, from -50 percent of non-oil GDP in 2022 to -43 percent of non-oil GDP in 2023, but this remains around 11 percentage points lower than the 2017-22 average.

External Accounts
(Percent of non-oil GDP)



Source: Central Bank of Timor-Leste (Estimation for 2023).

Oil Revenue
(Percent of non-oil GDP)



Sources: Central Bank of Timor-Leste; and IMF staff estimates.
(Projections for 2024-2025)

Assessment. The current account gap in 2023 was estimated at -12 percent of non-oil GDP. This suggests that the external sector position was substantially weaker than fundamentals and desirable settings. The current account was -20.4 percent of non-oil GDP and the current account norm was estimated at -8 percent of non-oil GDP. The current account gap is the difference between the actual current account and the current account norm. This weak external sector position reflects large fiscal imbalances and the limited development of the non-oil economy.

- Due to the very large sovereign wealth holdings that are not well captured by EBA-Lite's regression model, this (preferred) estimate of the current account norm was backed out from setting a norm for consumption as an annuity of total wealth. In turn, total wealth was equal to the sum of net foreign assets (above-ground wealth) and the present value of future oil revenues (below-ground wealth).
- Estimated net foreign assets by end-2023 were $18.7 billion and no oil revenues are expected from 2024 onward following the exhaustion of oil production at end-2023. Hence, total wealth was $18.7 billion. Assuming that the implicit real return on total wealth is 3 percent, then the current account norm (excluding oil revenues) in 2023 was around -$562 million (-31 percent of non-oil GDP). Since oil revenues were $0.4 billion (22 percent of non-oil GDP), the estimated current account norm was -8 percent of non-oil GDP, which compares to the actual current account balance of -20.4 percent of non-oil GDP.
- The current account gap estimated using the EBA-Lite regression model also suggests that the external sector position was substantially weaker than fundamentals and desirable policy settings. The current account gap was estimated at -45.5 percent of non-oil GDP, the current account norm at 24.4 percent of non-oil GDP, and the policy gap at -15.4 percent of non-oil GDP.

Timor-Leste: EBA-Lite Model Results, 2023

	CA model 1/	REER model 1/
	(in percent of GDP)	
CA-Actual	**-20.4**	
Cyclical contributions (from model) (-)	0.4	
Additional temporary/statistical factors (-) 2/	0.3	
Natural disasters and conflicts (-)	0.0	
Adjusted CA	**-21.1**	
CA Norm (from model) 3/	**24.4**	
Adjustments to the norm (-)	0.0	
Adjusted CA Norm	**24.4**	
CA Gap	**-45.5**	**-3.4**
o/w Relative policy gap	-15.4	
Elasticity	-0.1	
REER Gap (in percent)	**315.1**	**23.2**

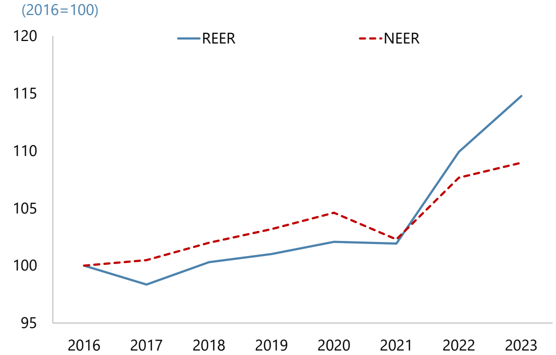
1/ Based on the EBA-lite 3.0 methodology
2/ Additional cyclical adjustment to account for the temporary impact of the pandemic tourism (-0.3 percent of GDP).
3/ Cyclically adjusted, including multilateral consistency adjustments.

Real Exchange Rate

Background. The nominal effective exchange rate (NEER) and real effective exchange rate (REER) appreciated by about 8 and 10 percent respectively during 2016–22. In the first three quarters of 2023, the REER appreciated by an additional 5 percentage points and the NEER by 1 percentage point, owing to global U.S. dollar strength and higher inflation in Timor-Leste than in trading partners.

Assessment. Using a standard trade elasticity of -0.14, a current account gap at -12 percent of GDP is equivalent to a REER gap of about 83 percent.

Effective Exchange Rates
(2016=100)



Sources: Central Bank of Timor-Leste; and IMF staff estimates. Q3 outturn for 2023

Capital and Financial Accounts: Flows and Policy Measures

Background. Portfolio inflows have been the main source of financing of current account deficits since 2016. They consist of withdrawals from the Petroleum Fund. In contrast, FDI inflows turned to outflows in 2019, averaging -4 percent of non-oil GDP since 2016 (excluding 2019-20 when there were exceptional outflows of -25 percent of non-oil GDP associated with foreign-owned natural gas operations coming to the end of their life).[3]

Assessment. No major vulnerabilities exist related to capital flows in the short and medium term, given the large size of the Petroleum Fund. Nonetheless, the current account deficit projected under the baseline is unsustainable in the long term.

FX Intervention and Reserves Level
Background. Reserves are estimated at $830 million at end-2023, amounting to about 9 months of imports of goods and services, 60 percent of broad money, 302 percent of external debt, and 45 percent of non-oil GDP.
Assessment. According to the template to Assess Reserve Adequacy in Credit-Constrained Economies, the optimal level of reserves for Timor-Leste is around 12 months of imports, much higher than the traditional metric of 3 months of imports. The benefits from holding reserves in the template are a function, among other variables, of the fiscal deficit, which for Timor-Leste is very large. However, the template neglects that Timor-Leste has a Petroleum Fund worth 189 months of imports.
[1] Non-oil GDP is estimated at about $1.8 billion in 2023. [2] Current account data available till Q3-2023. End-2023 current account data have been estimated by IMF staff. Current account gap reported as estimated by staff based on the NFA position. [3] Since the 2022 Article IV, there has been a large revision to historical FDI data following assistance from Fund CD on the balance of payments.

Annex III. Risk Assessment Matrix[1]

Source of Risk	Likelihood	Impact Direction (Degree)	Main Impacts → Recommended Policy Actions (Short-term = ST, Medium-term = MT)
External Risks			
Abrupt global slowdown or recession	Medium	↓ (Moderate)	ST/MT: Global and idiosyncratic risk factors combine to cause a synchronized sharp growth downturn, with recessions in some countries, adverse spillovers through trade and financial channels, and market fragmentation causing sudden stops in EMDEs. → Promote private sector development and the diversification of the economy. Mobilize domestic revenue to reduce the reliance on the PF to finance government spending.
Commodity price volatility	High	↓ (Moderate)	ST/MT: A succession of supply disruptions (e.g., due to conflicts, uncertainty, and export restrictions) and demand fluctuations causes recurrent commodity price volatility, external and fiscal pressures in EMDEs, contagion effects, and social and economic instability. → Support vulnerable households with targeted transfers to offset rising consumer prices. To create fiscal space, contain government spending pressures, mobilize domestic revenue, and align spending with sustainable revenues.
Domestic Risks			
Political fragmentation leads to social unrest	Medium	↓ (Moderate)	ST/MT: Following the parliamentary elections, the new government has a strong commitment to foster the reforms warranted to strengthen medium-term growth prospects. The inability to make progress on the campaigning promises may cause social unrest and further stall the reforms. → Work to achieve consensus surrounding reforms to improve the business environment, diversify the economy, and achieve fiscal sustainability.
Development of Greater Sunrise or other oil fields	Low Medium	↓↑ (Large)	MT: Significant oil revenues could support higher social spending and inclusive growth. Large public investment could deplete the PF more quickly. → Carefully assess benefits, costs, and risks from various development options before making investment decisions.
Over investment in projects with low returns	Medium	↓ (Large)	ST/MT: Large capital-intensive projects could yield low economic and social benefits and have large opportunity costs. → Strengthen project appraisal by developing a standard methodology and verifying that it is consistently applied across line ministries.
Extreme climate events	Medium	↓ (Moderate)	MT: Extreme climate events driven by rising temperatures or the regional El Niño phenomenon cause loss of human lives, severe damage to infrastructure, supply disruptions, lower growth, and financial instability.→ Continue to invest in infrastructure helping to limit the adverse impact of floods, establish contingency plans and early warnings systems.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("Low" is meant to indicate a probability below 10 percent, "Medium" a probability between 10 and 30 percent, and "High" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. The PF denotes the Petroleum Fund.

Annex IV. Integration of Capacity Development and Surveillance

Area	Surveillance Recommendations	Capacity Development Recent Actions/Plans
Tax Policy	Adopt a single rate VAT (¶17).	The Fund started supporting CD to prepare for VAT implementation through the PFTAC in October 2022.
Tax Administration	Strengthen tax administration to improve tax compliance (¶17).	The Fund provided a diagnostic review of tax administration in November 2021 and is following up with short-term expert assistance.
Fiscal Responsibility Legislation	Adopt a well-designed Fiscal Responsibility Law to improve fiscal discipline (¶18).	The Fund is ready to provide technical assistance through the Fiscal Affairs Department (FAD).
Public Financial Management (PFM)	Address PFM weaknesses to improve the quality of government spending (¶18).	The Fund supported CD through FAD and PFTAC to improve the authorities' Public Financial Management Strategy. They are also supporting CD on strengthening top-down budgeting.
Governance and AML/CFT	Strengthen the AML/CFT regime (¶22).	The AML/CFT framework is currently being assessed by APG in the context of Timor-Leste's third mutual evaluation.
Banking Sector Regulation and Financial Supervision	Enhance prudential standards and risk assessment methodologies to capture emerging risks in the financial sector (¶21).	The Fund is ready to provide technical assistance through PFTAC.
Macroeconomic statistics	Improve the quality and frequency of macroeconomic statistics (¶31).	The Fund reviewed the methodology and the compilation system of national accounts in collaboration through PFTAC, with the Australian statistical authorities. The Fund is supporting CD on external sector statistics and on government finance statistics through the Statistics Department (STA).
Financial Soundness Indicators (FSI)	Release FSI data without delay (¶31).	The Fund is ready to provide technical support through the STA.
Macroeconomic Analysis	Develop stronger analytical skills and better macroeconomic forecasting and policy analysis (¶8).	The Fund's Institute for Capacity Development (ICD) is supporting CD through the Singapore Training Institute and PFTAC to build a Financial Programing model for own use by the authorities.

Annex V. Responses to Past Fund Advice

Fund Recommendation	Policy Actions
Fiscal Policy	
• Fiscal consolidation and gradual elimination of Petroleum Fund (PF) excess withdrawals	The fiscal balance improved by 15 percent in 2022. The budget ceiling was lowered by 9 percent in the 2023 rectification budget. However, there is no medium-term fiscal framework to underpin continuous fiscal consolidation.
• Revenue mobilization and expenditure rationalization	The new government decided to reduce import duties and eliminate the tax on sugar and confectionary products. They also announced their plan to implement a VAT. CD for preparation for a VAT and top-down budgeting is in progress.
• Strengthen public financial management (PFM)	The authorities are revising their PFM Reform Strategy to be published in early 2024.
Financial Policies	
• Upgrade the financial sector regulatory and supervisory framework	The central bank issued the IRFS 9 and Basel III instructions, and private banks started the appropriate training. Full compliance is expected by December 2024. With the help of development partners, the central bank is drafting a new banking law that will incorporate all the changes in the regulations.
• Strengthen digital literacy, cybersecurity, and data/consumer protection and privacy	The new government plans to formulate and implement a national broadband plan, national cyber security plan, e-Government plan, and digital economy infrastructure plan.
Structural Reforms	
• Investment in human capital, raise productivity in the agriculture sector, conducive business environment including simplified licensing requirements and land registration, stronger governance, better enforcement of legal contracts, labor market reforms, investment in digital infrastructure.	The authorities plan to have technical assistance from IMF and World Bank on legal reforms for financial sector development. The AML/CFT framework is currently being assessed by APG in the context of Timor-Leste's third mutual evaluation. Other reform areas lack progress.
Statistics	
• Improve the quality of data for informed policy making.	Progress has been made, but further improvements are required in both the quality and frequency of official statistics, including for essential standard statistics such as national accounts, GFS, BOPS, MFS, and FSI.

INTERNATIONAL MONETARY FUND

DEMOCRATIC REPUBLIC OF TIMOR-LESTE

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

February 2, 2024

Prepared By

Asia and Pacific Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of December 31, 2023)

Membership Status: Joined July 23, 2002; Article VIII.

General Resources Account:

	SDR Million	% Quota
Quota	25.60	100.00
IMF Holdings of Currency (Holdings rate)	21.25	83.01
Reserve Tranche Position	4.35	17.00

SDR Department:

	SDR Million	% Allocation
Net Cumulative Allocation	32.26	100.00
Holdings	27.91	86.50

Outstanding Purchases and Loans: None

Latest Financial Commitments: None

Projected Payments to Fund:

(SDR Million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2024	2025	2026	2027	2028
Principal					
Charges/Interest	0.18	0.18	0.18	0.18	0.18
Total	0.18	0.18	0.18	0.18	0.18

Exchange Rate Arrangements:

The exchange rate arrangement (de jure and de facto) is an exchange arrangement with no separate legal tender. On January 24, 2000, the U.S. dollar was adopted as the official currency of then East Timor by the United Nations Transitional Administration in East Timor (UNTAET). This arrangement has been maintained after Timor-Leste's independence on May 20, 2002. At present, the monetary authority does not undertake foreign exchange transactions; they are handled by commercial banks on the basis of rates quoted in the international markets. Timor-Leste has accepted the obligations under Article VIII, Sections 2(a), 3 and 4 of the IMF's Articles of Agreement, and maintains an exchange system free of multiple currency practices and restrictions on the making of payments and transfers for current international transactions.

Article IV Consultations:

The previous Article IV consultation was concluded on June 23, 2022. The associated Executive Board assessment is available at https://www.imf.org/en/News/Articles/2022/09/22/pr22317-imf-executive-board-concludes-2022-article-iv-consultation-with-timor-leste and the staff report at https://www.imf.org/en/Publications/CR/Issues/2022/09/21/Democratic-Republic-of-Timor-Leste-2022-Article-IV-Consultation-Press-Release-and-Staff-523687. Timor-Leste is on the standard 12-month consultation cycle.

Resident Representative:

The resident representative office in Dili, established in August 2000, closed at end-June 2009.

INFORMATION ON THE ACTIVITIES OF OTHER INTERNATIONAL FINANCIAL INSTITUTIONS

Information on the activities of other international financial institutions in Timor-Leste can be found at:

- World Bank: http://www.worldbank.org/en/country/timor-leste
- Asian Development Bank: https://www.adb.org/countries/timor-leste/main

STATISTICAL ISSUES

(As of January 2024)

I. Assessment of Data Adequacy for Surveillance
General: Data provision to the IMF is broadly adequate for surveillance. Areas of concern include incomplete incorporation of the petroleum-related transactions and foreign direct investment in the balance of payments compilation following the new Maritime Boundary Treaty, weaknesses in compilation and dissemination of government finance statistics, and no public reporting of financial soundness indicators. The establishment of the National Institute of Statistics Timor-Leste as a public institute with autonomy was a good enhancement.
National Accounts: GDP is compiled annually by production, expenditure and income using a contemporary base period (2015) and using methods that are reasonably consistent with the *2008 System of National Accounts*. There has been significant improvement in shortening the time lag for publishing national accounts. The 2019 national accounts were published in October 2020 and the first preliminary 2020 GDP estimates were timely published in April 2021. Further, the preliminary 2021 and 2022 GDP estimates were published in March of the following years. The national accounts assume that oil production at the Joint Petroleum Development Area (JPDA) is resident in Timor-Leste since September 2019 as a result of the Maritime Boundary Treaty signed in August 2019 between Timor-Leste and Australia.
Price Statistics: The monthly, national CPI uses expenditure weights derived from the 2014–15 Living Standard Survey. Data are also released monthly for Dili, Baucau, and other regions. The CPI basket weights were updated in August 2018, and the CPI was rebased with an August 2018 reference period (August 2018 = 100).
Government Finance Statistics: Recent technical assistance (TA) missions have assisted the compilers to address capacity gaps and compile annual Government Finance Statistics (GFS), resulting in the resumption of regular GFS reporting for the central government to IMF STA which had been suspended since 2019. STA has also assisted the compilation of quarterly GFS, which has had been suspended since 2016 due to data discrepancies and challenges in resolving the source of those discrepancies. Data discrepancies between non-financial and financial transactions for GFS data remain. While Timor-Leste does not report to the Quarterly Public Sector Debt database jointly developed by the World Bank and IMF, the compilers have made progress in the compilation and dissemination of Public Sector Debt Statistics for the central government which currently comprises external loans.
Monetary and Financial Statistics: The central bank compiles monetary and financial statistics generally following the methodology of the *Monetary and Financial Statistics Manual and Compilation Guide*. The central bank reports detailed monthly monetary data for the central bank and other depository corporations using the standardized report forms in a timely manner. Timor-Leste uses the U.S. dollar as the official currency, and official data on currency holdings are difficult to compile under the current currency regime. Data for other financial corporations, mainly insurance companies, are in preparation for reporting to STA. The central bank reports data on some series and indicators of the Financial Access Survey, including mobile money and

the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the United Nations to monitor Target 8.10 of the Sustainable Development Goals (SDGs).
Financial Sector Surveillance: Only basic market-based indicators are available, and their coverage, precision, and timeliness vary across such indicators. Bank-specific balance sheet data and outstanding loan data is not sufficiently available to conduct stress tests of the banking system. Cross border exposure data for financial corporations are not available. Financial Soundness Indicators (FSIs) are not reported to STA.
External Sector Statistics: With support from the latest External Sector Statistics (ESS) TA mission in July 2023 by Capacity Development Office in Thailand, the central bank published balance of payments data through Q3/2023 that ensured methodological soundness and conformity with the new Maritime Boundary Treaty and the BPM6 compilation format. However, weak institutional settings, most importantly inter-institutional data sharing procedures, significantly affect ESS compilation. The shortages in source data continue to cause substantial data gaps and departures from the internationally accepted methodology. Most importantly, these include cross-border transactions in oil and gas sector, data on direct investment liabilities, including the absence of source data on intercompany debt and on large infrastructure projects executed by foreign contractors, and data on services. The solution would be to secure a high-level engagement in facilitating statistical and administrative source data exchange between government institutions and the BCTL to safeguard access of the BCTL to a wider range of administrative and statistical sources required for sound ESS compilation. While progress has been made, measuring non-Petroleum Fund-related current account transactions accurately remains work in progress. Monthly merchandise trade data are now published regularly. Data on monthly merchandise exports and imports are based on the Automated System for Customs Data. Service transactions are largely estimated with data collection limited to the official and tourism sectors. Quarterly balance of payments and international investment position data compiled by the central bank are available for 2006–Q3/2023 and 2008–Q2/2023, respectively, following the methodology outlined in the *Balance of Payments and International Investment Position Manual*, sixth edition. While the methodology to produce basic annual estimates of balance of payments statistics is in place, further development is needed to address limitations of existing data sources, including merchandise trade statistics and service transactions. This includes work to ensure consistency between current account data and the new national accounts statistics, particularly related to the exports of commodities and imports of services as well as to ensure consistency between the balance of payments and the international investment position. Currently, publicly available information on remittances from Timorese working abroad is limited, and improvement in the estimation and compilation procedures of such remittances should be pursued. The work should continue to fine-tune estimation models for remittances and collect data from the money transfers operators.

II. Data Standards and Quality
Timor-Leste is a participant in the IMF's Enhanced General Data Dissemination System (e-GDDS) and disseminates key economic data, albeit with delays and limited coverage, through the National Summary Data Page launched in February 2019.

Table 1. Timor-Leste: Table of Common Indicators Required for Surveillance

(As of November 30, 2023)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	10/2023	10/2023	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	09/2023	10/2023	M	M	M
Reserve/Base Money	09/2023	10/2023	M	M	M
Broad Money	09/2023	10/2023	M	M	M
Central Bank Balance Sheet	09/2023	10/2023	M	M	M
Consolidated Balance Sheet of the Banking System	09/2023	10/2023	M	M	M
Interest Rates[2]	09/2023	10/2023	M	M	M
Consumer Price Index	09/2023	10/2023	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2022	01/2023	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	2022	01/2023	A	A	A
Central Government and Central Government-Guaranteed Debt[5]	2022	01/2023	A	A	A
External Current Account Balance	Q3/2023	10/2023	Q	Q	Q
Exports and Imports of Goods and Services	Q3/2023	10/2023	Q	Q	Q
GDP/GNP	2022	08/2023	A	A	A
Gross External Debt	Q3/2023	10/2023	Q	Q	Q
International Investment Position[6]	Q3/2023	10/2023	Q	Q	Q

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic banks, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Includes only goods. There are significant gaps in the series. No information on services is available.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); NA: Not Available.

INTERNATIONAL MONETARY FUND

DEMOCRATIC REPUBLIC OF TIMOR-LESTE

February 2, 2024

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

Approved By
Ranil Salgado (IMF), Fabian Bornhorst (IMF), Lalita Moorty (IDA), and Manuela Francisco (IDA)

Prepared by Staff of the International Monetary Fund and the International Development Association

Timor-Leste: Joint Bank-Fund Debt Sustainability Analysis	
Risk of external debt distress	Moderate
Overall risk of debt distress	Moderate
Granularity in the risk rating	Limited space to absorb shocks
Application of judgement	Yes. Petroleum sovereign wealth fund is a strong mitigating factor for the country's debt sustainability in the next 10 years.

Timor-Leste remains at moderate risk of overall and external debt distress, with application of judgement, unchanged from the 2022 Article IV debt sustainability analysis. The present value of the external debt-to-exports ratio and the debt service-to-exports ratio under the baseline are projected to breach their respective indicative thresholds in the medium term, triggering a mechanical rating of high risk of overall and external debt distress. In the medium term, however, the Petroleum Fund is large relative to projected debt levels and debt service requirements, and its assets are liquid and accessible, thus acting as a mitigating factor, prompting the use of judgement to upgrade the risk assessment. Long-term risks to debt sustainability have moderated compared to the 2022 Article IV debt sustainability analysis, with smaller fiscal deficits in 2023-25 delaying the depletion of the Petroleum Fund. Staff now projects that the Petroleum Fund, which is the main source of funding of fiscal deficits, will be depleted in 2039, triggering a breach of all debt indicators towards the end of the twenty-year projection horizon. However, there is time to adopt necessary policy adjustments—staff's alternative scenario illustrates how fiscal consolidation and structural reforms can ensure both fiscal and debt sustainability in the long term.

PUBLIC DEBT COVERAGE

1. The coverage of public sector debt used in this report is public and publicly guaranteed debt. Timor-Leste's public and publicly guaranteed external debt is held entirely by the central government. The coverage of public sector debt includes state-owned enterprise debt. Under the Public Debt Regime Law, state-owned enterprises are not allowed to borrow for themselves and can only obtain financing via on-lending from the Ministry of Finance.[1] Currently, there are no guarantees granted by the state to state-owned enterprises. The Social Security Fund does not issue debt on its own. The public sector only borrows externally, given a lack of domestic financing sources. The debt definition of the debt sustainability analysis is currency-based, and the legal tender is the U.S. dollar.

Text Table 1. Timor-Leste's Coverage of Public Debt

	Subsectors of the public sector	Check box
1	Central government	X
2	State and local government	
3	Other elements in the general government	
4	o/w: Social security fund	
5	o/w: Extra budgetary funds (EBFs)	
6	Guarantees (to other entities in the public and private sector, including to SOEs)	X
7	Central bank (borrowed on behalf of the government)	
8	Non-guaranteed SOE debt	

2. The contingent liability stress test settings were customized (Text Table 2). The default shock to contingent liabilities from state-owned enterprises debt and Public Private Partnerships is reduced to zero. This is because the former is already included in the baseline public debt, and the latter is negligible (see ¶1).

Text Table 2. Coverage of Public Debt and Design of Contingent Liabilities (tailored) Stress Tests

1	The country's coverage of public debt	The central government, government-guaranteed debt		
		Default	Used for the analysis	Reasons for deviations from the default settings
2	Other elements of the general government not captured in 1.	0 percent of GDP	0	
3	SoE's debt (guaranteed and not guaranteed by the government) 1/	2 percent of GDP	0	Included in the baseline public debt
4	PPP	35 percent of PPP stock	0.00	Negligible PPP stock
5	Financial market (the default value of 5 percent of GDP is the minimum value)	5 percent of GDP	5	
	Total (2+3+4+5) (in percent of GDP)		5.0	

1/ The default shock of 2% of GDP will be triggered for countries whose government-guaranteed debt is not fully captured under the country's public debt definition (1.). If it is already included in the government debt (1.) and risks associated with SoE's debt not guaranteed by the government is assessed to be negligible, a country team may reduce this to 0%.

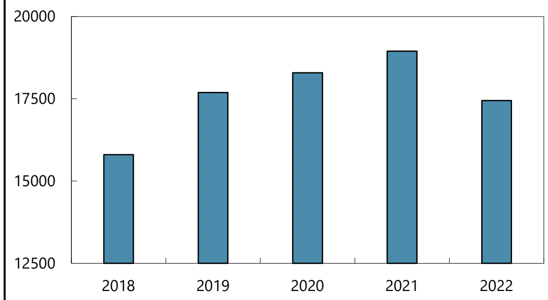
BACKGROUND ON DEBT

3. Timor-Leste's net public asset position is currently strong due to oil-related savings accumulated in Petroleum Fund assets and low levels of public debt.

[1]According to the Public Debt Regime Law No. 13/2011, the Government of Timor-Leste, in particular the Ministry of Finance, is the only entity that may engage in borrowing, motivated by financing needs generated by the need to execute the State's priority tasks relating to the building of strategic infrastructure for the country's development.

- The Petroleum Fund balance at end-2022 stood at $17.4 billion (1,039 percent of non-oil GDP), covering 187 months of prospective goods and services imports. The Petroleum Fund balance decreased by $2.4 billion in 2022 as unfavorable market revaluations ($-2.4 billion; -11.9 percent) and a large withdrawal ($1.4 billion; more than double the Fund's Estimated Sustainable Income) exceeded interest and dividend income ($596m) and oil revenues ($1.1 billion).[2] The average nominal return on Petroleum Fund assets during 2017–22 was 4.5 percent.

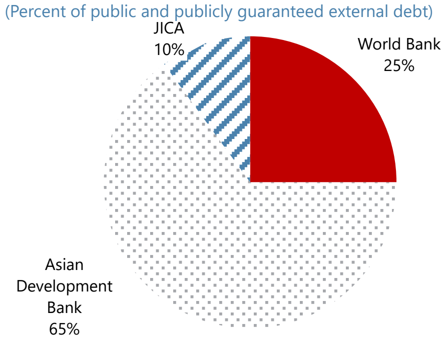
Text Figure 1. Petroleum Fund balance
(Million US dollars)



Source: Central Bank of Timor-Leste.

- The fiscal deficit increased from 45 percent of non-oil GDP in 2021 to 58 percent in 2022 due to significantly higher recurrent expenditure. Outstanding public external debt increased by $23 million and reached 15 percent of non-oil GDP ($258 million) in 2022. All external loans signed since 2012 have consisted of concessional loans from the Asian Development Bank, the World Bank Group, and the Japan International Cooperation Agency to finance mainly road infrastructure projects, water supply and sanitation, and development of the airport. The Asian Development Bank has the largest share of total external debt, comprising nearly 65 percent of total external debt at end-2022. The average maturity of existing loans is 25.5 years, with grace periods ranging from 5 to 10 years. Debt service payments on existing debt average $20 million (close to 1.2 percent of non-oil GDP) per annum in the medium term and decline thereafter.

Text Figure 2. External Debt by Creditors, 2022
(Percent of public and publicly guaranteed external debt)



Source: Ministry of Finance.

BACKGROUND ON MACRO FORECASTS

4. **Timor-Leste faces large and pressing development challenges**. Despite notable socio-economic achievements since gaining independence in 2002, Timor-Leste remains a fragile post-conflict state with weak human and institutional capacity, large infrastructure gaps, and high dependence on revenues from the Petroleum Fund. GNI per capita in current USD was $1,970 in

[2] The Petroleum Fund constitutes the main financing source for the budget. The Fund's estimated sustainable income (ESI) is set at 3 percent of total petroleum wealth (sum of the Petroleum Fund balance and the net present value of expected future petroleum revenue). The revenue rule—enshrined in the Petroleum Fund Law—limits the withdrawal for budget purpose from the Petroleum Fund up to the ESI. Withdrawals in excess of the ESI can be made with the approval of Parliament. The debt rule sets a ceiling on the cost of external borrowing at 3 percent and requires the government to benchmark the costs of external borrowing (external debt) with the Petroleum Fund's average rate of investment returns, subject to regular reviews to align with the Petroleum Fund's investment strategies.

2022, much lower than the threshold of at least $4,096 to be classified as an upper-middle income country. While the poverty rate (based on the national poverty line) declined from 50.4 percent in 2007 to 41.8 percent in 2014, it remains among the highest in the region.

5. **This debt sustainability analysis is based on the macroeconomic projections underlying the 2023 Article IV consultation (Text Table 3).** To illustrate the impact of different policy options on debt sustainability, two scenarios—baseline and reform—are considered.

Text Table 3. Main Macroeconomic Projections, 2020-28

	2020	2021	2022	2023	2024	2025	2026	2027	2028
				Est.	Proj.	Proj.	Proj.	Proj.	Proj.
Real sector									
Nominal Non-oil GDP (in millions of U.S. dollars)	1,581	1,560	1,672	1,829	1,979	2,124	2,277	2,439	2,613
Real Non-oil GDP growth (percent change)	-7.2	1.6	4.0	1.5	3.5	3.2	3.1	3.0	3.0
CPI (percent change, period average)	0.5	3.8	7.0	8.4	3.5	2.2	2.0	2.0	2.0
Non-oil GDP deflator growth (percent change)	1.2	-2.9	3.1	7.8	4.5	4.0	4.0	4.0	4.0
Central government operations	(In percent of Non-oil GDP)								
Revenue	57.5	58.8	57.3	49.2	46.1	42.4	39.2	36.1	33.3
Domestic revenue	11.5	10.3	10.3	10.0	10.1	10.2	10.3	10.4	10.6
Estimated Sustainable Income (ESI)	34.4	36.9	35.7	28.7	26.5	23.7	21.3	18.9	16.7
Grants	11.6	11.6	11.4	10.5	9.4	8.5	7.6	6.8	6.0
Expenditure	83.4	104.1	115.5	90.7	88.9	85.7	82.8	80.0	77.4
Recurrent expenditure	61.7	83.5	92.0	68.0	65.4	63.1	60.9	58.8	56.8
Capital expenditure	10.1	9.0	12.1	12.2	14.1	14.2	14.3	14.4	14.5
Donor project	11.6	11.6	11.4	10.5	9.4	8.5	7.6	6.8	6.0
Net lending/borrowing	-25.8	-45.2	-58.2	-41.5	-42.8	-43.4	-43.7	-43.9	-44.0
	(In millions of U.S. dollars, unless otherwise indicated)								
Balance of payments									
Current account balance	-281	151	273	-372	-832	-930	-1,027	-1,139	-1,238
Trade balance	-607	-1,340	-1,959	-1,234	-885	-939	-995	-1,053	-1,115
Exports	-295	-591	-1,054	-346	73	83	95	109	125
Imports	639	749	906	887	958	1,022	1,091	1,162	1,239
Services (net)	-217	-153	-150	-154	-181	-207	-232	-257	-262
Primary Income 1/	608	1,638	2,452	1,091	316	303	295	283	265
Secondary Income	-65	7	-69	-75	-81	-87	-94	-111	-127
Balance of payments	(In percent of Non-oil GDP, unless otherwise indicated)								
Current account balance	-17.7	9.7	16.3	-20.3	-42.0	-43.8	-45.1	-46.7	-47.4
Trade balance	-38.4	-85.9	-117.2	-67.4	-44.7	-44.2	-43.7	-43.2	-42.7
Exports	-18.6	-37.9	-63.0	-18.9	3.7	3.9	4.2	4.5	4.8
Imports	40.4	48.0	54.2	48.5	48.4	48.1	47.9	47.7	47.4
Services (net)	-13.7	-9.8	-9.0	-8.4	-9.1	-9.7	-10.2	-10.5	-10.0
Primary Income 1/	38.5	105.0	146.6	59.6	15.9	14.3	12.9	11.6	10.1
Secondary Income	-4.1	0.4	-4.1	-4.1	-4.1	-4.1	-4.1	-4.5	-4.8
Memorandum items									
Public external debt (In millions of U.S. dollars)	219	235	253	275	284	311	325	333	351
(In percent of Non-oil GDP)	13.8	15.1	15.1	15.0	14.3	14.7	14.3	13.6	13.4
Petroleum Fund balance (in millions of U.S. dollars) 2/	18,991	19,732	17,379	17,503	16,772	16,130	15,391	14,560	13,646
(In months of imports)	255	254	187	189	165	147	130	114	101
(In percent of Non-oil GDP)	1201	1265	1039	957	848	760	676	597	522
Crude oil prices (U.S. dollars per barrel, WEO) 3/	42	69	96	81	79	75	72	72	72

Sources: Timor-Leste authorities; and IMF staff estimates and projections.

1/ Oil sector activities are considered non-resident activities in balance of payments statistics.

2/ Closing balance.

3/ Simple average of UK Brent, Dubai, and WTI crude oil prices; October 2023 WEO assumptions.

6. Several macro-fiscal developments recently have improved significantly compared to the 2022 Article IV debt sustainability analysis (Text Table 4). The following revisions were made to reflect recent developments and the latest data. First, the Petroleum Fund's outstanding balance at end-2022 included a valuation of about $701 million (close to 4 percent of the Petroleum Fund balance) for the investment in the Greater Sunrise oil fields by Timor-Gap (the national oil company) financed by the Petroleum Fund, which had previously been written down to zero in the 2020 financial statement.[3] Second, the 2022 budget envisaged much larger fiscal deficit spending on an expanded envelope for capital expenditures, but these plans were abandoned in the new government's 2023 rectification budget. Finally, the courts blocked the transfer of $1 billion from the Petroleum Fund to finance support programs for war veterans through the new National Liberation Combatants Fund, which had been included in the baseline for the 2022 debt sustainability analysis.

Text Table 4. Macroeconomic and Fiscal Assumptions: Current and 2022 Article IV

	Current (2023 Article IV)				Previous (2022 Article IV)			
	2022	2023	2024-28	2029-43	2021	2022	2023-27	2028-42
Real non-oil GDP growth (in percent)	4.0	1.5	3.2	3.0	1.5	3.3	2.9	3.0
CPI inflation	7.0	8.4	2.3	2.1	3.8	7.0	2.5	2.0
Revenue (excl. grants, percent of non-oil GDP)	46.0	38.6	31.6	17.0	42.6	40.4	30.0	15.3
Government expenditure (percent of non-oil GDP)	104.1	80.0	74.8	56.9	85.8	95.3	82.9	50.8
Recurrent	92.0	67.9	60.6	43.6	77.5	79.0	59.0	43.7
Capital	12.1	12.1	14.2	13.4	8.3	16.3	23.9	7.1
Net lending/borrowing (percent of non-oil GDP)	58.2	41.4	43.2	39.9	43.2	54.9	52.9	35.5
Net incurrence of liabilities (percent of non-oil GDP)	2.2	3.2	3.3	0.8	2.7	2.7	2.4	2.0
Petroleum Fund balance (USD million)	17,379	17,503	15,305	4,489	18,949	17,446	14,772	4,708
Current account balance (percent of non-oil GDP)	16.3	-20.4	-44.8	-43.5	2.5	-15.3	-41.4	-40.0

Sources: Timor-Leste authorities; and IMF staff estimates and projections.

Macroeconomic Assumptions

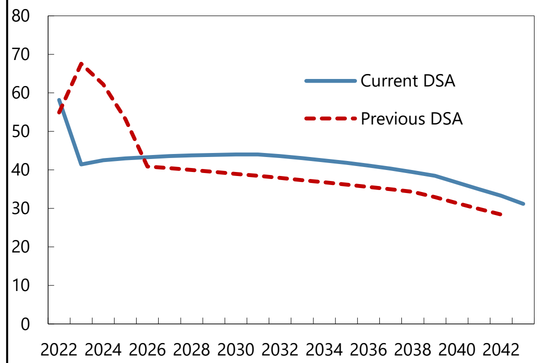
- **Real non-oil GDP growth** is projected to slow from 4.0 percent in 2022 to 1.5 percent in 2023, weighed down by a strong contraction in public expenditure. Growth will recover to 3.5 percent in 2024 supported by the new government's prioritization of public capital expenditure in the budget. Growth is projected to hover around 3.0 percent in the medium and long term (2028–2043), driven by the private sector and broadly aligned with historical (non-oil) growth performance of 3.2 percent during 2010-19. Oil production from active fields ceased by end-2023 and is not projected to restart in the baseline scenario.[4]
- **Inflation** increased sharply to a peak of almost 10 percent y/y in 2022, mostly driven by food prices. While prices of non-food items have stabilized, food inflation remains high and has held back the moderation of headline inflation, which averaged 8.4 percent in 2023. With the easing of global commodity prices in recent months, inflation is expected to ease to 3.5 percent in 2024 and return to 2 percent in the medium term, in line with the previous debt sustainability analysis.

[3] The audited financial statements for Timor-Gap in 2020 wrote down the investment in Greater Sunrise triggered by uncertainty of the fiscal and regulatory regime of the Greater Sunrise field. However, the position's valuation was restored in the 2021 Petroleum Fund account and is accounted for in this DSA.

[4] Non-oil and oil GDP are equal from 2024 onwards. The baseline does not include the development of the Greater Sunrise fields as development plans are not yet approved.

- **The fiscal deficit** is projected to decrease from 58 percent of non-oil GDP in 2022 to 42 percent in 2023 and remain around that level until 2030. The projected deficits over 2023-25 are much smaller than what had been forecast in the previous DSA, which anticipated a peak deficit of 68 percent of non-oil GDP in 2023. Notably, the large increase in capital expenditures envisaged for 2023-25 in the 2022 budget has not materialized, and oil revenues in 2023 were much higher than expected. As envisaged in the 2024 budget, a modest rebound in expenditure is expected in 2024 that includes an expansion of capital expenditure and contains spending on transfers. During 2025-27, the fiscal stance is projected to be mildly expansionary, reflecting the new government's plans to prioritize public spending on human and physical capital. The fiscal deficit is projected to remain around 40 percent over 2031-39, and to gradually decline thereafter, reaching 31 percent of GDP in 2043. Over 30 percent of public expenditure is expected to be allocated for government transfers in 2023, down from 52 percent in 2022, and this share is expected to decline modestly over the longer term as capital expenditures are prioritized.

Text Figure 3. Fiscal Deficit
(Percent of non-oil GDP)



Source: IMF staff estimates.

- **The current account deficit** is expected to increase from 21 percent of non-oil GDP in 2023 to about 42 percent in 2024, increasing slightly to around 47 percent by 2030, reflecting the projected fiscal path, absence of oil revenues, strong imports of goods and services, and limited exports. The medium-term current account deficit is largely unchanged since the last DSA, but it has been revised up by 10 percentage points of non-oil GDP due to statistical revisions to the denominator. In the long term, the current account deficit gradually declines as the domestic production of tradeable goods expands. Remittances are assumed to grow in line with non-oil GDP.

- **External financing** consists of concessional loans from official creditors. Private external borrowing is assumed to remain negligible. Timor-Leste does not have exceptional financing such as accumulation of arrears. There is no domestic financing assumed in the baseline, though the new administration has expressed an interest in developing an issuance program for government bills in the local market.

- **The grant element of loans** is assumed to decline moderately in the medium term as the economy develops. Other assumptions include that no off-budget debt is accumulated including by state-owned enterprises in line with existing legislation.

7. The baseline fiscal scenario assumes lower spending than planned under the 2023 rectification budget and the 2024 budget, reflecting historical execution rates. Capital and recurrent spending in 2023 is assumed to be close to 90 percent of the planned amount in the 2023 rectification budget, which itself internalized substantial under-execution of the 2023 budget through August 2023. For 2024, an execution rate of about 85 percent is assumed out of the planned amount in the 2024 budget. An annual nominal investment return on the Petroleum Fund of around 4.5 percent is assumed during 2023-30—in line with its average returns over 2017–22—after which a smaller return of 4 percent is assumed to reflect a shift into more liquid investments as the Fund's balance falls.

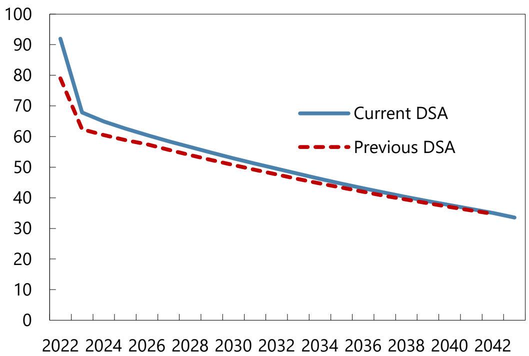
- Government revenues (which include the Petroleum Fund's estimated sustainable income) are projected to decline from 46 percent of non-oil GDP in 2022 to about 39 percent in 2023 and average around 32 and 17 percent respectively during 2024-28 and 2029-43. In the baseline, there is a gradual erosion in the balance of the Petroleum Fund which in turn reduces its estimated sustainable income. The government has signaled its intention to raise domestic revenue from 10 percent currently to around 15 percent of non-oil GDP in the medium term.[5] While the baseline scenario assumes a moderate increase in domestic revenue over the long term, it envisages the ratio rising from 10 percent to only about 12 percent of non-oil GDP by 2043.
- Recurrent spending in the long term is projected to increase by 3.5 percent each year, broadly in line with projected population growth and inflation. Capital spending is projected to increase by around 8 percent during 2024-28 (and around 5 percent in the long term), up from 2 percent in the previous debt sustainability analysis to reflect the new government's prioritization of public investment and its much lower starting level following the abandonment of the 2022 budget's planned investment ramp-up.
- As the government relies on Petroleum Fund withdrawals to meet its financing needs, the Petroleum Fund falls to $13.6 billion by 2028. The fund is completely depleted by 2039—one year later than in the previous debt sustainability analysis—after which it is assumed that the government relies on external debt to finance fiscal deficits.[6]
- External borrowing is projected at about 1.5 percent of non-oil GDP during 2023–28 in line with updated borrowing plans shared by the authorities and slightly below recent values. The average maturity and grace periods of the new external loans are broadly similar with existing loans, though the baseline incorporates access to IDA Shorter Maturity Loans (SMLs) during 2023-25.[7] Outstanding external debt as a share of non-oil GDP is projected to decline slightly from 15 percent in 2022 to 13.5 percent in 2028, reflecting growth of nominal non-oil GDP and the projected disbursement of external loans. However, once the Petroleum Fund depletes in 2039, external borrowing is assumed to be the main source of financing of the fiscal deficit, with the stock of external debt rising to around 180 percent of non-oil GDP by 2043 under the baseline.

[5] The authorities are working on further upgrading their tax collection system, including moving to electronic tax services; however, the underlying law changes essential for the upgraded systems to be functional have not yet been undertaken. Draft laws for a value-added tax (VAT) and a new Tax Procedure Code were prepared some years ago. Submitting these to the Parliament in 2023 were the FY2023 Performance and Policy Actions (PPAs) established by the IDA in consultation with the Ministry of Finance. However, the authorities are currently unable to fulfill these agreed upon PPAs, resulting in a 10 percent set-aside of the IDA allocation for this fiscal year.

[6] The Ministry of Finance projects higher levels of public expenditure than staff over the medium term, and thus expects the PF to be fully depleted by 2034.

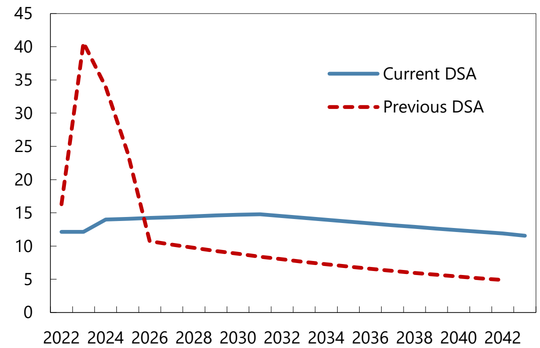
[7] For Timor-Leste, SMLs comprise approximately 24 percent of its IDA's country allocation. SMLs have a 12-year final maturity, a 6-year grace period, and zero interest or service charge.

Text Figure 4. Recurrent Spending
(Percent of non-oil GDP)



Source: IMF staff estimates.

Text Figure 5. Capital Spending
(Percent of non-oil GDP)



Source: IMF staff estimates.

8. **While the baseline scenario is identified as potentially unrealistic, there are plausible and relevant mitigating factors that suggest it does not warrant adjustments.** The three-year primary balance adjustment (between 2022 and 2025) is projected to be 15 percent of non-oil GDP: this represents one of the ten largest adjustments in the distribution of Fund-supported programs in low-income countries since 1990. However, most of this consolidation already took place in 2023 reflecting low budget execution rates, particularly in public investment. As some of the unexecuted investment projects are expected to be delayed and resume next year, the fiscal stance will loosen somewhat in 2024, supporting growth. The contribution to growth from public investment, however, is expected to be lower than in the previous DSA, given the large downward revision to capital expenditures in the 2023 budget. The impact of the consolidation explains the downward revision to growth in 2023, but a relatively low multiplier of 0.1 is assumed. If the multiplier turns out to be larger, growth could be lower or negative in the short term.

Text Table 5. Macroeconomic Assumptions: Baseline and Reform Scenarios

			Baseline			Reform (Recommended)		
	2022	2023	2024	2025-28	2039-43	2024	2025-28	2039-43
	Percent of non-oil GDP (unless noted otherwise)							
Real non-oil GDP growth (in percent)	4.0	1.5	3.5	3.1	3.0	2.5	3.0	6.2
Revenue (excl. grants)	46.0	38.5	36.5	30.4	13.5	38.0	35.5	21.1
Domestic revenue	10.3	10.0	10.1	10.4	13.5	11.4	14.2	15.1
Estimated Sustainable Income	35.7	28.4	26.4	20.0	0.0	26.6	21.3	6.0
Expenditure	104.1	80.0	78.9	73.8	48.4	73.9	58.2	21.1
Recurrent	92.0	67.9	65.0	59.5	36.3	59.8	44.8	14.2
Capital	12.1	12.1	14.0	14.3	12.1	14.1	13.3	6.9
Net lending/borrowing	-58.2	-41.6	-42.5	-43.4	-34.9	-36.0	-22.7	0.1
Financing								
PF excess withdrawals	48.3	48.0	49.8	42.7	0.4	43.3	21.0	0.0
PF closing balance ($ million)	17,379	17,503	16,774	14,938	0	16,910	16,207	17,266
Current account balance	16.3	-20.4	-42.0	-45.5	-38.6	-38.0	-33.9	-6.6

Source: IMF staff estimates.

9. Under staff's reform scenario—which is broadly consistent with the scenario that has been previously presented in the 2021 and 2022 DSAs—policy actions are adopted to safeguard long-term fiscal sustainability.

- **Domestic revenue mobilization**: A VAT is adopted by 2024 to generate additional revenue of about 3 percent of GDP, raising domestic revenue to about 13 percent of non-oil GDP by 2025. Over the medium term, strengthening of tax compliance through tax administration reforms and further tax policy measures (e.g., revision of excise tax rates, increase in statutory income tax rate, adopting a property tax) further increase domestic revenue to about 15.5 percent of non-oil GDP. Along with these initiatives, structural reforms (¶11) are estimated to yield additional revenue growth of about 6 percent (annualized average) during 2024-43 relative to the baseline.

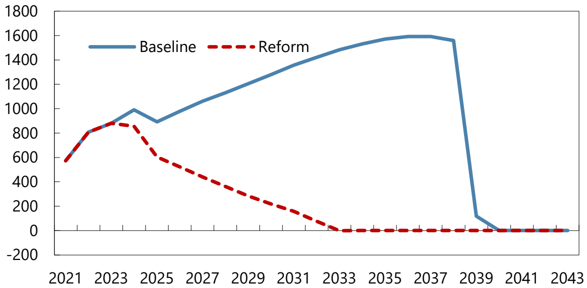
- **Expenditure moderation:** Government expenditure declines gradually to the 2019 level as a share of non-oil GDP, allowing for the elimination of excess withdrawals from the Petroleum Fund by 2033. The quality of government spending is improved by curbing growth in salary, goods, and services expenditures and allocating more spending towards human capital development and a strengthened social safety net. Capital expenditure is kept stable as a share of non-oil GDP—at higher levels than in the baseline scenario—and its growth dividend is boosted through rigorous cost-benefit analysis.[8]

- **A target to achieve a sustainable fiscal position by 2033:** More moderate levels of spending coupled with higher domestic revenue gradually unwind fiscal imbalances and align withdrawals from the Petroleum Fund with its sustainable income. The strong fiscal outturns in 2023 mean that the path to fiscal sustainability in the reform scenario is more gradual than it was in the 2022 DSA, and thus allows for stronger short-term growth. The Petroleum Fund balance will gradually increase to close to $20 billion in the long run, and the estimated sustainable income will decline more slowly in percent of non-oil GDP.[9] Fiscal deficits over the medium-term (2025–28) would average 23 percent of non-oil GDP, instead of 44 percent of non-oil GDP under the baseline. Overall, in the reform scenario the Petroleum Fund is preserved from 2033 onwards and generates a permanent level of investment income to support government expenditures, thus putting fiscal and debt sustainability on a solid footing.

[8] The revised Budgetary Framework and Public Financial Management Law, passed in February 2022 will help enhance the efficiency and quality of government spending. However, for it to be effective, a concrete action plan of PFM reforms with technical support from the Fund should be laid out and implemented swiftly with help from other development partners.

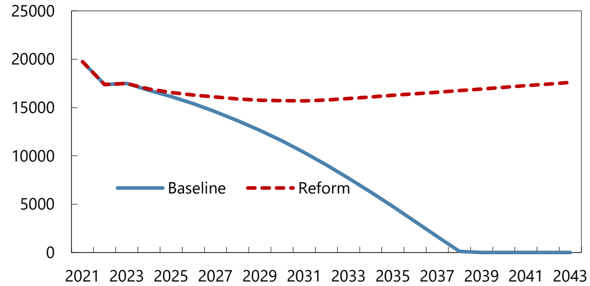
[9] The dynamic of the Petroleum Fund is such that a lower Petroleum Fund balance will reduce the level of estimated sustainable income, resulting in higher excess withdrawals to close a given financing gap, highlighting the need to curb the rapid loss in Petroleum Fund wealth.

Text Figure 6. PF Excess Withdrawal
(Million US dollars)



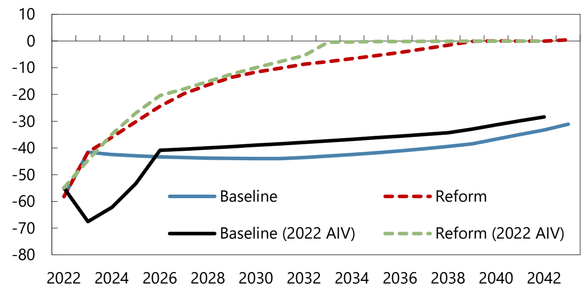
Source: IMF staff estimates.

Text Figure 7. PF Balance
(Million US dollars)



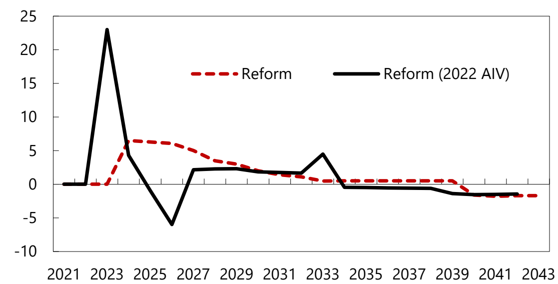
Source: IMF staff estimates.

Text Figure 8. Fiscal Primary Balance
(Percent of non-oil GDP)



Source: IMF staff estimates.

Text Figure 9. Added Fiscal Effort for Reforms
(Diff. in primary balance; percent of non-oil GDP)



Source: IMF staff estimates.

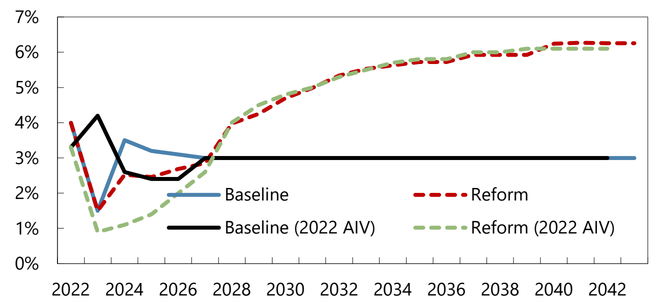
- The government's strategy of increasing public external borrowing via concessional loans to finance public investment in infrastructure projects and to preserve the Petroleum Fund wealth continues to hold. Overall, external borrowing is significantly lower in 2038–43 as the Petroleum Fund is preserved and public spending increases in line with higher sustainable sources of revenue.

10. At the same time, structural reforms are implemented to improve the business environment, raise productivity, and promote private sector development.[10] These include progress in facilitating the ease of doing business, shifting from subsistence to commercial agriculture, addressing digital infrastructure and connectivity bottlenecks, increasing financial access, building human capacity, closing labor skill gaps, and strengthening the justice system to improve governance and reduce corruption vulnerabilities. The authorities laid out medium-term measures in the Economic Recovery Plan 2020–23, focusing on the abovementioned priorities, to address pre-existing structural weaknesses for long-term growth.

[10] Staff estimates suggest the external sector position in 2023 was substantially weaker than implied by medium-term fundamentals and desirable policy settings.

11. The macro-fiscal outlook is significantly stronger under the reform scenario:

Text Figure 10. Real Non-Oil GDP Growth
(Percent)



Source: IMF staff estimates.

- **Real non-oil GDP** is somewhat lower than in the baseline in the short run owing to the output costs of fiscal consolidation.[11] However, these are mitigated by the positive impact of reprioritization (towards growth-enhancing sectors such as health, education, agriculture, tourism, digitalization), by the improvement in the quality of public spending, and by structural reforms to promote the expansion of the private sector.[12] With sustained improvement in productivity and competitiveness, the economic impact of structural reforms is higher over the long term (2031–2043), where growth is projected to hover around 5-6 percent—significantly higher than under the baseline—driven by higher private investment and the development of the non-oil private sector, reduced import dependence, and a larger export base.

- **The current account deficit** over the medium and long term is projected to be considerably smaller in comparison to the baseline scenario, reflecting both higher exports (economic diversification and exports of high value-added agricultural exports) and lower imports of goods and services (in line with lower fiscal spending and lower reliance on food imports).

COUNTRY CLASSIFICATION AND DETERMINATION OF SCENARIO STRESS TESTS

12. The debt-carrying capacity is assessed to be weak (Text Table 6). Timor-Leste's debt carrying capacity is assessed to be weak according to the Composite Indicator index of 2.68—barely below the 2.69 threshold—, which is calculated based on the October 2023 World Economic Outlook and the 2022 Country Policy and Institutional Assessment. The Composite Indicator is based on a weighted average of the country's real GDP growth, remittances, international reserves,

[11] Timor-Leste's fiscal multiplier, measured by the change in real non-oil GDP growth rate induced by a unit change in the primary balance (in percent of GDP), is estimated to be close to 0.1-0.15. This is in line with other estimates in the literature which estimate it to be in the range of 0.08-0.17. Low multipliers indicate that much of the spending leaks into imports and/or is low quality reflecting supply-side constraints. The long-run multiplier is assumed to be 0.

[12] The positive impact of structural reforms often take time to materialize and could even entail short-term costs (e.g., labor and product market reforms). This is consistent with the macroeconomic impact of structural reforms seen across various IMF-supported programs (see Andritzky and others, 2021). Structural reforms are estimated to have a positive impact on real GDP growth of around 0.3 percentage points in the medium-term, and 2.5 percentage points over the long run.

world growth, and the Country Policy and Institutional Assessment score.[13] Accordingly, the debt sustainability analysis thresholds applicable for Timor-Leste are: 30 percent for the present value of the external debt-to-GDP ratio, 140 percent for the present value of the external debt-to-exports ratio, 10 percent for the external debt service to-exports ratio, 14 percent for the external debt service-to-revenue ratio, and 35 percent for the present value of the public debt-to-GDP ratio.

Text Table 6. Timor-Leste Debt Carrying Capacity and Thresholds

Debt Carrying Capacity and Thresholds

Country	Timor-Leste
Country Code	**537**
Debt Carrying Capacity	**Weak**

Final	Classification based on current vintage	Classification based on the previous vintage	Classification based on the two previous vintage
Weak	Weak 2.68	Weak 2.68	Weak 2.66

APPLICABLE THRESHOLDS	
EXTERNAL debt burden thresholds	
PV of debt in % of	
Exports	140
GDP	30
Debt service in % of	
Exports	10
Revenue	14

APPLICABLE THRESHOLDS	
TOTAL public debt benchmark	
PV of total public debt in percent of GDP	35

13. **The size of the shock to the non-debt creating flows (foreign direct investment)-to-GDP ratio, and net current transfers-to-GDP and -to-exports was customized to account for one-off and structural factors.** First, there is a large outflow in foreign direct investment equivalent to $575 million in 2019 due to Petroleum Fund's investment in Timor-Gap to purchase the 56 percent stake in the Greater Sunrise joint venture.[14] To prevent this one-off deviation in foreign direct investment flows from inflating the foreign direct investment-to-GDP ratio shock, the

[13] The calculation is based on 10-year averages of the variables, across 5 years of historical data and 5 years of projections, and the corresponding Country Policy and Institutional Assessment.

[14] Timor Gap is an autonomous government agency with the mandate to conduct oil and gas business on behalf of the Timor-Leste Government.

historical average and the standard deviation corresponds to 2011–21 (excluding 2019).[15] Second, to prevent the structural oil production cycle from inflating the export shock and to account for the fact that petroleum production ceased in 2023, the export stress test was customized in line with the 2021 and 2022 Article IV consultation debt sustainability analyses. Third, the increase in Timorese workers' remittance outflows abroad has resulted in a shift from net current transfers inflows to net outflows in the last five years, which is projected to continue until the end of the projection horizon. To account for this shift, the historical average and the standard deviation of the current transfers-to-GDP shock corresponds to 2017–21.

14. The commodity price shocks were introduced in a tailored stress test, with adjustments made to the default settings. Lack of export diversification has resulted in excessive reliance of Timor-Leste's external position on petroleum and gas receipts—the share of commodity exports in Timor-Leste's total exports is 90 percent on average over 2019–21. However, this is projected to decline to close to 60 percent on average over 2022–24, as the petroleum production from active fields comes to an end in 2023. Hence, the commodity price shock is tailored by adjusting the share of fuel in total exports of goods and services to match the latter.

15. A tailored stress test on natural disasters is added to the sensitivity analysis given that Timor-Leste is prone to natural disasters. The default setting (10 percent of GDP increase in debt stock, 1.5 percent decline in real GDP growth, and 3 percent decline in exports growth) was modified so that the stress test captures Timor-Leste's most recent experience with the cyclone and floods in April 2021.[16] The tailored stress test assumes that a natural disaster occurs in 2024 and that new debt is contracted to finance damages, increasing the public debt-to-GDP ratio by 14 percent in 2023, which is equivalent to the estimated damages from the April 2021 floods.[17] Real GDP and exports growth decline by 2 percent and 4 percent in FY2023, respectively, relative to the baseline.[18]

ASSESSMENT

External Debt Sustainability Analysis

16. Under the baseline scenario, two of Timor-Leste's external debt indicators breach their respective debt sustainability analysis thresholds in the medium-term (Figure 1). First, the

[15] The customization implied that: (i) the historical average of the net non-debt creating flows (foreign direct investment)-to-GDP ratio is revised up from -1.5 to 2.8 and the standard deviation is reduced from 13.5 to 2.2; (ii) the initial standard deviation of 56.5 of the export shock was scaled down to 11.3; and (iii) the historical average of the current official transfers-to-GDP ratio is revised from 3.9 to -5.4 and the standard deviation is reduced from 13.7 to 2.2.

[16] See Selected Issues Paper for the 2022 Article IV consultation.

[17] See World Bank (2021) report on "Learning from Tropical Cyclone Seroja: Building Disaster and Climate Resilience in Timor-Leste."

[18] The damages from Tropical Cyclone Seroja in April 2021 are estimated at US$245 million, which is historically the highest available estimates for economic damages. According to the International Disaster Database, the economic damages from previous natural disasters range from US$4 million to US$20 million.

present value of external debt in percent of exports breaches the indicative threshold of 140 percent between 2024 and 2028. Second, the debt service to exports ratio breaches the indicative threshold of 10 percent between 2024–30 (Figure 1). All other indicators remain well below their relevant thresholds for the next fifteen years. Debt dynamics reflect the following: (i) increase in debt service payments as grace periods on existing loans come to an end; and (ii) projected disbursement of external loans over the medium term and, thereafter, the government's strategy of increasing public external borrowing via concessional loans to reduce the need to tap the Petroleum Fund from the projected expansion of public investment in infrastructure projects. Over the medium term, the present value of external debt is projected to decline somewhat from 17 percent of non-oil GDP in 2023 to 14 percent in 2032 but will increase thereafter as the PF is depleted.

17. Debt dynamics show vulnerability to shocks to the primary balance, natural disasters, exports, contingent liabilities, and commodity prices. Standardized stress tests show that a shock to the primary balance and exports are the most extreme shocks to the debt trajectory, also causing breaches of the debt service-to-exports and the present value of debt-to-exports thresholds. Timor-Leste's high vulnerability to shocks reflects its very small exports and revenue bases, and, therefore, its exposure to high debt service payment risks if its Petroleum Fund assets are not taken into account.

Public Debt Sustainability Analysis

18. Under the baseline scenario, the present value of the total public and publicly guaranteed debt-to-GDP ratio remains below the threshold level for the next fifteen years (Figure 2). However, this indicator is vulnerable to commodity price shocks and is expected to breach the threshold under the stress scenario starting in 2026. The Petroleum Fund is depleted towards the end of the twenty-year projection horizon, leading to all debt indicators breaching their respective debt sustainability analysis thresholds (Figure 1). This is projected to lead to a substantial jump in external borrowing resulting in a breach of all debt thresholds beyond 2039.

Reform Scenario

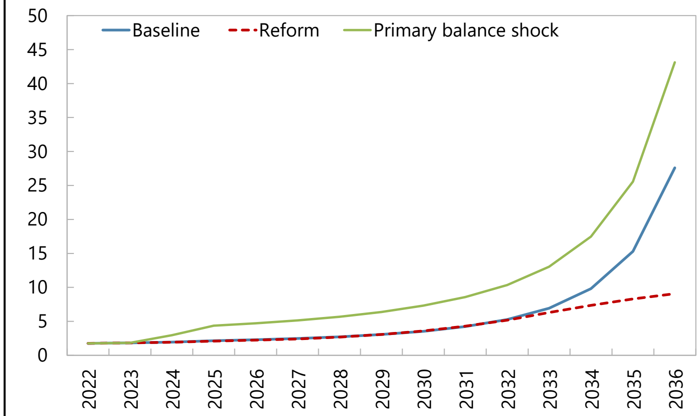
19. Staff's reform scenario illustrates how fiscal consolidation coupled with structural reforms can ensure long-term fiscal and debt sustainability. The introduction of reforms significantly improves debt dynamics—the paths of debt burden indicators are better—over the next twenty years. The duration of the breach of the present value of external debt in percent of exports and the debt service-to-exports ratio in the medium-term is also smaller compared to the baseline. Importantly, the Petroleum Fund is stabilized and generates a sustainable stream of resources to finance the budget.

RISK RATING AND VULNERABILITIES

20. While the debt sustainability analysis assigns Timor-Leste a mechanical rating of high risk of debt distress, judgement is applied to upgrade the rating to moderate. Under the

Text Figure 11. Petroleum Fund Buffer

(Present Value of Public External Debt-to-Petroleum Fund balance ratio, in percent)



Source: IMF staff calculations.

baseline scenario, the present value of debt-to-exports and debt service-to-exports breach the benchmark over 2024-30—generating a mechanical debt distress rating of high. The use of judgement invokes the country's large, liquid, and accessible net foreign assets saved in the Petroleum Fund, which serves as a strong mitigating factor allowing Timor-Leste to carry and service debt until 2039, even under the scenario of the most extreme shock case (i.e., the primary balance shock).[19] The present value of debt does not exceed more than 25 percent of the projected value of the Petroleum Fund until 2036 under the baseline (Text Figure 11). Under the scenario of the most extreme shock case (i.e., primary balance shock), the present value of debt-to-Petroleum Fund assets reaches close to 43 percent by 2036. There is still time for the authorities to undertake the necessary policy adjustment to stabilize the Petroleum Fund balance (see ¶21). Conditional on the implementation of these reforms (¶22), the debt is sustainable. With this, the risk of debt distress—both external and overall—is assessed as "moderate" with limited space to absorb shocks (see Figure 5), which is unchanged from the previous 2022 DSA rating.

21. The projected depletion of the Petroleum Fund within the 20-year horizon under current policies makes the case for urgent fiscal consolidation and implementation of important structural reforms. Although the Petroleum Fund is projected to be depleted by 2039 under the baseline, it could be depleted much faster—for instance, with a nominal investment return of 2.5 percent, it would be depleted by 2037. Fiscal consolidation aiming to achieve a sustainable fiscal position in a 10-year horizon, supported by expenditure rationalization and domestic revenue mobilization, would allow decreasing withdrawals from the Petroleum Fund until they reach a level consistent with preserving the Petroleum Fund. This process should go hand in hand with structural reforms to improve the business environment and governance, enhance competitiveness, and strengthen the external sector position. The analysis also highlights the importance of enhancing the resilience to natural disasters and climate change, including by prioritizing climate adaptation investment. Lack of political consensus is a risk that could impede the reforms that are warranted to put the fiscal position on a sustainable footing and strengthen medium-term growth prospects. Although that risk has a high probability of materializing, the implementation of the reforms has higher probability. The development of the Greater Sunrise fields is uncertain given difficulties in finding a commercially viable option that is acceptable to all stakeholders.

[19] The stock of outstanding public debt was 1 percent of the Petroleum Fund balance at end-2022.

22. The IMF and the World Bank stand ready to support the authorities in their efforts to ensure fiscal and debt sustainability. The authorities are aware of the challenge and requested extensive technical assistance from the IMF for ambitious fiscal reforms aiming to secure fiscal sustainability. As discussed in the Country Engagement Strategy prepared as part of the 2023 Article IV consultation, ongoing technical assistance on public financial management reforms by the IMF Fiscal Affairs Department, on revenue administration by the IMF Pacific Financial Technical Assistance Center, and on governance in anti-money laundering by the IMF Legal Department will support the authorities in ensuring fiscal and debt sustainability. The adoption of the Major Planning Options Law as specified in the new basic PFM law aims to bring more predictability to the budget process. The approval of a new procurement law that came into effect in January 2023 is intended to increase transparency and simplify the procurement process. The authorities also welcomed Fund assistance on a Fiscal Responsibility Law to help improve fiscal discipline. Moreover, the World Bank and the International Finance Corporation (IFC) have plans to provide technical assistance to improve the prospects for private sector development including ease of doing business, agriculture, and tourism.

23. At the same time, public debt management needs to be strengthened.[20] External borrowing should be embedded in a suitable institutional framework, supported by best practice debt management policies and procedures. Strengthening the organization and capacity of the debt management unit, including preparing a medium-term debt management strategy (MTDS), and upgrading debt recording software are key areas for capacity building. However, in the near term, there is a need to produce comprehensive and realistic debt servicing projections for the existing debt. The monitoring and reporting of fiscal risks—such as contingent liabilities related to credit guarantees, pensions, public corporations, and public-private partnerships—should also be improved.

AUTHORITIES' VIEWS

24. While the authorities broadly agreed with staff's debt sustainability analysis and on the need to achieve fiscal sustainability, they emphasized urgent development needs. They agreed that their spending plans would lead to the eventual depletion of the Petroleum Fund and have flagged that—under the spending plans and forecasts that are outlined in the latest budget—depletion could occur by 2034. However, they emphasized that the PF's balance remains large, and that accelerating growth and development were key to achieving fiscal sustainability. Over the medium term, they will calibrate fiscal policy to achieve the government's development objectives, including through prioritizing investment in infrastructure. The authorities agreed on the need to mobilize domestic tax revenues and improve tax administration and will prioritize VAT implementation, but agreed with staff on the need to proceed gradually.

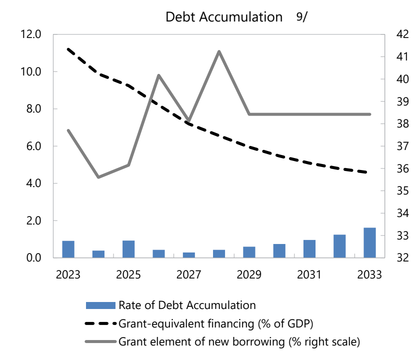
[20] There have not been any noteworthy improvements in data coverage and public debt management since the 2019 Article IV.

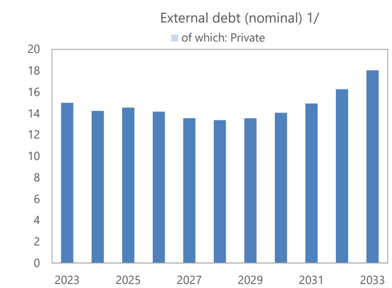
Table 1. Timor-Leste: External Debt Sustainability Framework, Baseline Scenario, 2020-2043

(In percent of GDP, unless otherwise indicated)

	Actual			Projections								Average 8/	
	2020	2021	2022	2023	2024	2025	2026	2027	2028	2033	2043	Historical	Projections
External debt (nominal) 1/	**13.8**	**15.1**	**15.1**	**15.0**	**14.2**	**14.5**	**14.2**	**13.6**	**13.4**	**18.0**	**178.0**	**8.1**	**14.7**
of which: public and publicly guaranteed (PPG)	**13.8**	**15.1**	**15.1**	**15.0**	**14.2**	**14.5**	**14.2**	**13.6**	**13.4**	**18.0**	**178.0**	**8.1**	**14.7**
Change in external debt	2.4	1.2	0.1	-0.1	-0.8	0.3	-0.4	-0.6	-0.2	1.8	19.2		
Identified net debt-creating flows	**59.6**	**-5.1**	**-15.6**	**21.8**	**43.1**	**44.8**	**46.0**	**47.3**	**47.7**	**47.3**	**31.2**	**-18.1**	**44.5**
Non-interest current account deficit	**17.6**	**-10.0**	**-16.9**	**19.9**	**41.6**	**43.3**	**44.7**	**46.0**	**46.3**	**46.0**	**32.4**	**-22.9**	**43.1**
Deficit in balance of goods and services	40.6	-2.2	-21.0	25.9	51.2	49.4	46.4	42.4	41.9	35.5	19.1	**-1.9**	**40.7**
Exports	25.1	56.2	72.9	29.5	7.6	8.0	8.5	9.0	9.5	12.8	23.5		
Imports	65.8	54.0	52.0	55.4	58.8	57.4	54.9	51.3	51.4	48.3	42.6		
Net current transfers (negative = inflow)	4.1	-0.4	4.1	4.1	4.1	4.1	4.1	4.2	4.3	3.7	0.8	**-0.7**	**4.1**
of which: official	-11.6	-11.6	-11.4	-10.5	-9.4	-8.5	-7.6	-6.8	-6.0	-3.3	-1.0		
Other current account flows (negative = net inflow)	-27.1	-7.4	0.0	-10.1	-13.8	-10.2	-5.9	-0.7	0.1	6.8	12.5	**-20.3**	**-1.8**
Net FDI (negative = inflow)	**41.1**	**4.4**	**1.7**	**1.6**	**1.5**	**1.5**	**1.4**	**1.4**	**1.3**	**1.1**	**0.7**	**4.7**	**1.3**
Endogenous debt dynamics 2/	**0.8**	**0.5**	**-0.5**	**0.3**	**0.0**	**0.0**	**0.0**	**0.0**	**0.1**	**0.3**	**-1.9**		
Contribution from nominal interest rate	0.1	0.3	0.5	0.5	0.4	0.4	0.4	0.4	0.5	0.7	2.5		
Contribution from real GDP growth	0.9	-0.2	-0.6	-0.2	-0.5	-0.4	-0.4	-0.4	-0.4	-0.5	-4.4		
Contribution from price and exchange rate changes	-0.1	0.4	-0.5	...	...	...	...	...	...	...	...		
Residual 3/	**-57.2**	**6.4**	**15.7**	**-21.9**	**-43.8**	**-44.5**	**-46.4**	**-47.9**	**-47.9**	**-45.6**	**-12.0**	**19.6**	**-44.3**
of which: exceptional financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Sustainability indicators													
PV of PPG external debt-to-GDP ratio	**...**	**...**	**18.3**	**17.5**	**16.4**	**16.2**	**15.5**	**14.7**	**14.2**	**14.5**	**115.9**		
PV of PPG external debt-to-exports ratio	**...**	**...**	**25.0**	**59.3**	**216.2**	**201.6**	**183.3**	**164.6**	**149.3**	**113.3**	**493.7**		
PPG debt service-to-exports ratio	**1.4**	**1.2**	**1.7**	**4.0**	**16.5**	**15.5**	**14.1**	**12.5**	**11.1**	**9.0**	**14.4**		
PPG debt service-to-revenue ratio	**0.8**	**1.5**	**2.8**	**3.1**	**3.4**	**3.7**	**3.8**	**3.8**	**3.9**	**6.1**	**24.3**		
Gross external financing need (Million of U.S. dollars)	934.2	-76.5	-231.9	416.2	883.5	984.4	1083.3	1188.4	1277.7	1778.1	2705.0		
Key macroeconomic assumptions													
Real GDP growth (in percent)	-7.2	1.6	4.0	1.5	3.5	3.2	3.1	3.0	3.0	3.0	3.0	**1.0**	**2.9**
GDP deflator in US dollar terms (change in percent)	1.2	-2.9	3.1	8.0	5.0	4.1	3.9	3.9	3.9	4.0	5.0	**2.9**	**4.4**
Effective interest rate (percent) 4/	0.9	2.0	3.8	3.3	3.2	3.3	2.8	2.7	3.6	4.9	1.7	**1.6**	**3.9**
Growth of exports of G&S (US dollar terms, in percent)	-55.0	120.5	39.1	-55.7	-72.0	13.3	12.9	13.5	13.5	13.7	15.4	**6.2**	**-0.6**
Growth of imports of G&S (US dollar terms, in percent)	-1.9	-19.0	3.2	16.8	15.4	4.9	2.4	0.1	7.2	5.7	6.0	**-5.4**	**6.8**
Grant element of new public sector borrowing (in percent)	...	...	...	37.7	35.6	36.1	40.2	38.1	41.2	38.4	38.4	**...**	**38.3**
Government revenues (excluding grants, in percent of GDP)	45.9	47.2	46.0	38.6	36.5	33.7	31.4	29.3	27.3	19.0	14.0	**48.5**	**27.9**
Aid flows (in Million of US dollars) 5/	183.1	181.0	190.0	202.0	192.8	191.6	185.1	172.8	170.0	153.0	679.2		
Grant-equivalent financing (in percent of GDP) 6/	...	...	...	11.2	9.9	9.2	8.2	7.2	6.6	4.6	13.3	**...**	**7.1**
Grant-equivalent financing (in percent of external financing) 6/	...	...	...	90.4	92.4	87.3	90.8	91.5	89.5	69.4	40.3	**...**	**84.7**
Nominal GDP (Million of US dollars)	1,581	1,560	1,672	1,833	1,992	2,140	2,292	2,453	2,625	3,689	7,408		
Nominal dollar GDP growth	-6.1	-1.4	7.2	9.6	8.7	7.4	7.1	7.0	7.0	7.1	8.2	**4.0**	**7.5**
Memorandum items:													
PV of external debt 7/	...	...	18.3	17.5	16.4	16.2	15.5	14.7	14.2	14.5	115.9		
In percent of exports	...	...	25.0	59.3	216.2	201.6	183.3	164.6	149.3	113.3	493.7		
Total external debt service-to-exports ratio	1.4	1.2	1.7	4.0	16.5	15.5	14.1	12.5	11.1	9.0	14.4		
PV of PPG external debt (in Million of US dollars)			305.2	320.4	327.5	346.0	355.2	361.8	372.4	533.7	8588.8		
(PVt-PVt-1)/GDPt-1 (in percent)				0.9	0.4	0.9	0.4	0.3	0.4	1.6	22.8		
Non-interest current account deficit that stabilizes debt ratio	15.2	-11.2	-17.0	20.0	42.3	43.0	45.0	46.6	46.5	44.2	13.2		

Definition of external/domestic debt	**Currency-based**
Is there a material difference between the two criteria?	**No**





Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

3/ The residual in debt-creating flows is financed through excess withdrawals from the Petroleum Fund. Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Current-year interest payments divided by previous period debt stock.

5/ Defined as grants, concessional loans, and debt relief.

6/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

7/ Assumes that PV of private sector debt is equivalent to its face value.

8/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

9/ The grant element may be overestimated due to debt projections.

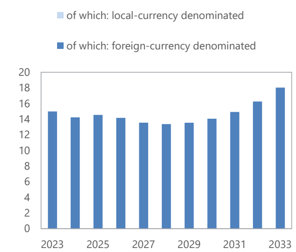
Table 2. Timor-Leste: Public Sector Debt Sustainability Framework, Baseline Scenario, 2020-2043

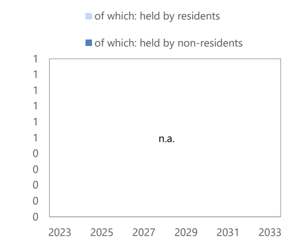
(In percent of GDP, unless otherwise indicated)

	Actual			Projections								Average 7/	
	2020	2021	2022	2023	2024	2025	2026	2027	2028	2033	2043	Historical	Projections
Public sector debt 1/	**13.8**	**15.1**	**15.1**	**15.0**	**14.2**	**14.5**	**14.2**	**13.6**	**13.4**	**18.0**	**178.0**	**8.1**	**14.7**
of which: external debt	**13.8**	**15.1**	**15.1**	**15.0**	**14.2**	**14.5**	**14.2**	**13.6**	**13.4**	**18.0**	**178.0**	**8.1**	**14.7**
Change in public sector debt	2.4	1.2	0.1	-0.1	-0.8	0.3	-0.4	-0.6	-0.2	1.8	19.2		
Identified debt-creating flows	**26.6**	**45.4**	**57.2**	**40.1**	**41.3**	**42.0**	**42.3**	**42.6**	**42.9**	**42.0**	**19.2**	**36.0**	**42.3**
Primary deficit	**25.7**	**45.0**	**57.6**	**40.9**	**42.0**	**42.5**	**42.9**	**43.2**	**43.3**	**42.3**	**28.7**	**35.9**	**42.7**
Revenue and grants	57.5	58.8	57.3	49.1	45.9	42.2	39.0	36.0	33.3	22.3	15.0	**61.3**	**34.3**
of which: grants	11.6	11.6	11.4	10.5	9.4	8.5	7.6	6.8	6.0	3.3	1.0		
Primary (noninterest) expenditure	83.3	103.8	115.0	90.1	87.9	84.7	81.9	79.3	76.6	64.6	43.7	**97.3**	**77.0**
Automatic debt dynamics	**0.8**	**0.5**	**-0.5**	**-0.9**	**-0.8**	**-0.6**	**-0.6**	**-0.6**	**-0.4**	**-0.3**	**-9.5**		
Contribution from interest rate/growth differential	0.8	-0.1	-0.7	-0.7	-0.6	-0.3	-0.3	-0.3	-0.2	0.0	-4.8		
of which: contribution from average real interest rate	-0.1	0.1	-0.1	-0.5	-0.1	0.1	0.1	0.1	0.2	0.5	-0.2		
of which: contribution from real GDP growth	0.9	-0.2	-0.6	-0.2	-0.5	-0.4	-0.4	-0.4	-0.4	-0.5	-4.6		
Contribution from real exchange rate depreciation	0.1	0.6	0.2	...	...	...	...	...	...	...	...		
Other identified debt-creating flows	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Recognition of contingent liabilities (e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Debt relief (HIPC and other)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Other debt creating or reducing flow (please specify)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Residual 2/	**-24.2**	**-44.2**	**-57.1**	**-40.3**	**-42.2**	**-41.9**	**-43.0**	**-43.5**	**-43.3**	**-40.5**	**-4.7**	**-34.5**	**-42.3**
Sustainability indicators													
PV of public debt-to-GDP ratio 3/	**...**	**...**	**18.3**	**17.5**	**16.4**	**16.2**	**15.5**	**14.7**	**14.2**	**14.5**	**115.9**		
PV of public debt-to-revenue and grants ratio	**...**	**...**	**31.8**	**35.6**	**35.8**	**38.3**	**39.7**	**40.9**	**42.6**	**64.9**	**775.2**		
Debt service-to-revenue and grants ratio 4/	**0.6**	**1.2**	**2.2**	**2.4**	**2.7**	**2.9**	**3.0**	**3.1**	**3.2**	**5.2**	**22.6**		
Gross financing need 5/	26.0	45.4	58.9	42.1	43.3	43.8	44.1	44.3	44.4	43.5	32.1		
Key macroeconomic and fiscal assumptions													
Real GDP growth (in percent)	-7.2	1.6	4.0	1.5	3.5	3.2	3.1	3.0	3.0	3.0	3.0	**1.0**	**2.9**
Average nominal interest rate on external debt (in percent)	0.9	2.0	3.8	3.3	3.2	3.3	2.8	2.7	3.6	4.9	1.7	**1.6**	**3.9**
Average real interest rate on domestic debt (in percent)	-0.3	5.1	0.6	-4.3	-1.7	-0.8	-1.0	-1.1	-0.3	0.9	-3.2	**-1.0**	**-0.4**
Real exchange rate depreciation (in percent, + indicates depreciation)	0.4	4.4	1.4	...	...	...	...	...	...	...	...	**-0.7**	**...**
Inflation rate (GDP deflator, in percent)	1.2	-2.9	3.1	8.0	5.0	4.1	3.9	3.9	3.9	4.0	5.0	**2.9**	**4.4**
Growth of real primary spending (deflated by GDP deflator, in percent)	-6.6	26.6	15.2	-20.5	1.1	-0.6	-0.3	-0.4	-0.4	-0.7	-2.1	**1.3**	**-2.1**
Primary deficit that stabilizes the debt-to-GDP ratio 6/	23.3	43.7	57.6	41.1	42.8	42.2	43.3	43.8	43.5	40.5	9.5	**41.5**	**42.5**
PV of contingent liabilities (not included in public sector debt)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		

Definition of external/domestic debt	**Currency-based**
Is there a material difference between the two criteria?	**No**

Public sector debt 1/





Sources: Country authorities; and staff estimates and projections.

1/ Coverage of debt: The central government, government-guaranteed debt. Definition of external debt is Currency-based.

2/ The residual in debt-creating flows is financed through excess withdrawals from the Petroleum Fund.

3/ The underlying PV of external debt-to-GDP ratio under the public DSA differs from the external DSA with the size of differences depending on exchange rates projections.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term, and short-term debt.

5/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period and other debt creating/reducing flows.

6/ Defined as a primary deficit minus a change in the public debt-to-GDP ratio ((-): a primary surplus), which would stabilizes the debt ratio only in the year in question.

7/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

Table 3. Timor-Leste: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2023-2043

(In percent)

	Projections 1/																				
	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036	2037	2038	2039	2040	2041	2042	2043
PV of debt-to GDP ratio																					
Baseline	17	16	16	15	15	14	14	14	14	14	14	16	17	20	23	27	**48**	**68**	**86**	**103**	**116**
A. Alternative Scenarios																					
A1. Key variables at their historical averages in 2023-2043 2/	17	-24	-66	-110	-154	-199	-244	-288	-330	-370	-407	-441	-471	-498	-522	-542	-543	-540	-536	-530	-523
B. Bound Tests																					
B1. Real GDP growth	17	18	20	19	18	17	17	16	16	17	17	19	21	24	28	**33**	**58**	**82**	**104**	**124**	**140**
B2. Primary balance	17	25	**33**	**32**	**31**	30	29	28	28	27	27	28	29	**31**	**33**	**37**	**58**	**77**	**95**	**111**	**124**
B3. Exports	17	23	26	25	24	23	22	22	22	22	22	23	25	27	**31**	**36**	**62**	**87**	**109**	**129**	**146**
B4. Other flows 3/	17	21	24	23	22	22	21	21	20	20	20	21	22	24	27	**31**	**51**	**71**	**89**	**105**	**118**
B5. Depreciation	17	21	11	10	9	9	9	9	9	10	11	13	16	19	24	30	**56**	**82**	**105**	**125**	**142**
B6. Combination of B1-B5	17	23	14	13	12	12	11	11	11	12	13	15	18	21	26	**32**	**59**	**86**	**110**	**131**	**149**
C. Tailored Tests																					
C1. Combined contingent liabilities	17	20	19	18	18	17	17	16	16	16	17	18	20	22	25	29	**50**	**70**	**88**	**104**	**118**
C2. Natural disaster	17	26	26	26	26	25	25	25	25	25	26	27	29	**31**	**35**	**39**	**61**	**81**	**100**	**117**	**130**
C3. Commodity price	17	17	18	17	16	16	15	15	15	15	15	16	18	20	24	28	**49**	**69**	**87**	**103**	**116**
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	30	30	30	30	30	30	30	30	30	30	30	30	30	30	30	30	30	30	30	30	30
PV of debt-to-exports ratio																					
Baseline	59	**216**	**202**	**183**	**165**	**149**	137	127	120	115	113	115	119	128	**141**	**158**	**262**	**350**	**417**	**466**	**494**
A. Alternative Scenarios																					
A1. Key variables at their historical averages in 2023-2043 2/	59	-318	-827	-1301	-1723	-2095	-2418	-2696	-2913	-3075	-3184	-3248	-3271	-3259	-3214	-3140	-2959	-2774	-2591	-2411	-2225
B. Bound Tests																					
B1. Real GDP growth	59	**216**	**202**	**183**	**165**	**149**	137	127	120	115	113	115	119	128	**141**	**158**	**262**	**350**	**417**	**466**	**494**
B2. Primary balance	59	**328**	**410**	**375**	**341**	**311**	**285**	**263**	**243**	**226**	**213**	**204**	**200**	**200**	**205**	**216**	**314**	**396**	**458**	**503**	**527**
B3. Exports	59	**432**	**512**	**467**	**421**	**383**	**352**	**326**	**304**	**286**	**274**	**270**	**274**	**285**	**306**	**336**	**540**	**711**	**841**	**937**	**990**
B4. Other flows 3/	59	**270**	**302**	**276**	**250**	**227**	**209**	**193**	**179**	**166**	**157**	**152**	**152**	**156**	**165**	**178**	**279**	**364**	**429**	**476**	**502**
B5. Depreciation	59	**216**	107	96	84	76	70	65	63	66	71	78	88	101	118	138	**245**	**335**	**405**	**456**	**485**
B6. Combination of B1-B5	59	**309**	130	**159**	**141**	127	117	109	104	105	109	117	129	**145**	**166**	**193**	**337**	**458**	**550**	**619**	**658**
C. Tailored Tests																					
C1. Combined contingent liabilities	59	**258**	**240**	**218**	**197**	**179**	**164**	**152**	**143**	136	132	132	136	**143**	**154**	**170**	**273**	**360**	**426**	**475**	**502**
C2. Natural disaster	59	**394**	**374**	**350**	**324**	**301**	**282**	**265**	**251**	**240**	**232**	**228**	**228**	**233**	**242**	**257**	**374**	**472**	**546**	**600**	**628**
C3. Commodity price	59	**273**	**253**	**222**	**194**	**171**	**153**	**142**	133	127	124	124	128	136	**148**	**165**	**271**	**360**	**428**	**478**	**506**
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	140	140	140	140	140	140	140	140	140	140	140	140	140	140	140	140	140	140	140	140	140
Debt service-to-exports ratio																					
Baseline	4	**17**	**16**	**14**	**13**	**11**	**11**	**10**	**10**	10	9	8	8	8	8	8	7	**10**	**12**	**13**	**14**
A. Alternative Scenarios																					
A1. Key variables at their historical averages in 2023-2043 2/	4	**17**	4	-9	-21	-31	-39	-45	-71	-93	-112	-128	-141	-151	-159	-164	-168	-167	-165	-163	-158
B. Bound Tests																					
B1. Real GDP growth	4	**17**	**16**	**14**	**13**	**11**	**11**	**10**	**10**	10	9	8	8	8	8	8	7	**10**	**12**	**13**	**14**
B2. Primary balance	4	**17**	**18**	**19**	**17**	**15**	**14**	**14**	**16**	**18**	**17**	**15**	**14**	**13**	**13**	**12**	**12**	**14**	**15**	**17**	**17**
B3. Exports	4	**29**	**32**	**31**	**27**	**24**	**23**	**22**	**23**	**24**	**22**	**20**	**19**	**19**	**18**	**17**	**17**	**22**	**25**	**28**	**30**
B4. Other flows 3/	4	**17**	**17**	**16**	**15**	**13**	**12**	**12**	**13**	**14**	**13**	**12**	**11**	**10**	10	10	9	**12**	**13**	**15**	**15**
B5. Depreciation	4	**17**	**16**	**12**	**11**	9	9	9	9	6	5	5	5	6	6	6	6	9	**11**	**12**	**13**
B6. Combination of B1-B5	4	**21**	**22**	**17**	**15**	**13**	**13**	**13**	**13**	9	9	8	8	8	8	8	8	**12**	**15**	**17**	**18**
C. Tailored Tests																					
C1. Combined contingent liabilities	4	**17**	**16**	**15**	**13**	**12**	**11**	**11**	**11**	**10**	9	9	8	8	8	8	8	**10**	**12**	**14**	**15**
C2. Natural disaster	4	**19**	**21**	**20**	**18**	**16**	**15**	**15**	**14**	**13**	**13**	**12**	**11**	**11**	**10**	**10**	**10**	**13**	**15**	**17**	**18**
C3. Commodity price	4	**20**	**18**	**16**	**14**	**12**	**11**	**11**	**11**	**11**	10	9	9	9	8	8	8	**11**	**12**	**14**	**15**
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10
Debt service-to-revenue ratio																					
Baseline	3	3	4	4	4	4	4	5	5	6	6	7	7	8	9	10	10	**15**	**18**	**22**	**24**
A. Alternative Scenarios																					
A1. Key variables at their historical averages in 2023-2043 2/	3	4	1	-2	-6	-11	-15	-20	-37	-55	-75	-98	-123	-149	-178	-207	-236	-246	-254	-261	-266
B. Bound Tests																					
B1. Real GDP growth	3	4	4	5	5	5	5	6	6	7	7	8	9	9	10	12	13	**18**	**22**	**26**	**29**
B2. Primary balance	3	3	4	5	5	5	6	6	8	11	11	12	13	13	**14**	**15**	**16**	**20**	**24**	**27**	**29**
B3. Exports	3	4	5	5	5	5	6	6	7	9	9	10	11	12	12	14	**15**	**20**	**24**	**28**	**31**
B4. Other flows 3/	3	3	4	4	4	5	5	5	7	8	9	9	10	10	11	12	13	**17**	**20**	**23**	**26**
B5. Depreciation	3	4	5	4	4	4	5	5	6	4	5	5	6	7	8	9	10	**16**	**21**	**25**	**28**
B6. Combination of B1-B5	3	4	5	4	4	4	5	5	7	5	6	6	7	8	9	10	11	**17**	**22**	**26**	**30**
C. Tailored Tests																					
C1. Combined contingent liabilities	3	3	4	4	4	4	4	5	5	6	6	7	7	8	9	10	11	**15**	**19**	**22**	**24**
C2. Natural disaster	3	3	4	5	5	5	5	6	6	7	7	8	8	9	10	11	12	**16**	**20**	**23**	**26**
C3. Commodity price	3	3	4	4	4	4	4	5	5	6	7	7	8	8	9	10	11	**15**	**19**	**22**	**25**
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14

Sources: Country authorities; and staff estimates and projections.
1/ A bold value indicates a breach of the threshold.
2/ Variables include real GDP growth, GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
3/ Includes official and private transfers and FDI.

Table 4. Timor-Leste: Sensitivity Analysis for Key Indicators of Public Debt, 2023-2033
(In percent)

	Projections 1/										
	2023	**2024**	**2025**	**2026**	**2027**	**2028**	**2029**	**2030**	**2031**	**2032**	**2033**
	PV of Debt-to-GDP Ratio										
Baseline	17	16	16	15	15	14	14	14	14	14	14
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2023-2043 2/	17	12	6	-2	-11	-20	-31	-42	-54	-67	-79
B. Bound Tests											
B1. Real GDP growth	17	20	26	30	32	35	**37**	**39**	**42**	**44**	**46**
B2. Primary balance	17	25	33	32	31	30	29	28	28	27	27
B3. Exports	17	19	21	20	19	18	18	18	17	17	18
B4. Other flows 3/	17	21	24	23	22	22	21	21	20	20	20
B5. Depreciation	17	20	18	16	14	12	10	8	7	6	6
B6. Combination of B1-B5	17	23	22	17	17	16	15	15	15	15	16
C. Tailored Tests											
C1. Combined contingent liabilities	17	20	19	18	18	17	17	16	16	16	17
C2. Natural disaster	17	26	26	26	26	25	25	25	25	25	26
C3. Commodity price	17	22	33	**43**	**52**	**61**	**70**	**78**	**86**	**93**	**101**
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Public debt benchmark	35	35	35	35	35	35	35	35	35	35	35
	PV of Debt-to-Revenue Ratio										
Baseline	36	36	38	40	41	43	45	48	52	57	65
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2023-2043 2/	36	26	14	-4	-29	-59	-97	-143	-199	-263	-335
B. Bound Tests											
B1. Real GDP growth	36	44	60	73	86	101	117	134	154	176	201
B2. Primary balance	36	54	78	81	85	89	94	99	105	113	122
B3. Exports	36	40	49	51	53	55	58	62	66	72	79
B4. Other flows 3/	36	45	57	60	62	65	68	73	77	83	90
B5. Depreciation	36	45	44	41	38	35	33	30	28	26	26
B6. Combination of B1-B5	36	50	51	44	46	47	50	53	57	63	71
C. Tailored Tests											
C1. Combined contingent liabilities	36	43	46	47	49	51	54	57	62	68	76
C2. Natural disaster	36	57	62	67	71	75	81	88	95	105	117
C3. Commodity price	36	48	78	110	145	184	228	276	329	388	452
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	Debt Service-to-Revenue Ratio										
Baseline	2.4	2.7	2.9	3.0	3.1	3.2	3.5	3.9	4.3	4.8	5.2
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2023-2043 2/	2.4	2.8	2.8	2.6	2.2	1.7	1.3	0.8	-0.9	-3.2	-6.2
B. Bound Tests											
B1. Real GDP growth	2.4	3.0	3.6	4.0	4.3	4.7	5.4	6.2	7.5	9.1	10.8
B2. Primary balance	2.4	2.7	3.4	4.1	4.2	4.3	4.6	5.1	7.0	9.1	9.6
B3. Exports	2.4	2.7	3.1	3.3	3.4	3.5	3.8	4.2	5.0	5.9	6.3
B4. Other flows 3/	2.4	2.7	3.2	3.6	3.6	3.7	4.0	4.5	5.6	6.8	7.3
B5. Depreciation	2.4	3.1	3.8	3.8	3.8	3.7	4.0	4.4	4.4	4.4	4.4
B6. Combination of B1-B5	2.4	2.7	3.0	3.1	3.2	3.3	3.6	4.1	4.5	4.9	5.4
C. Tailored Tests											
C1. Combined contingent liabilities	2.4	2.7	3.1	3.2	3.3	3.4	3.7	4.1	4.6	5.0	5.4
C2. Natural disaster	2.4	2.8	3.6	3.7	3.9	4.0	4.4	4.9	5.4	5.9	6.3
C3. Commodity price	2.4	2.7	3.3	4.1	4.9	5.8	7.1	8.5	10.9	14.6	18.6
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

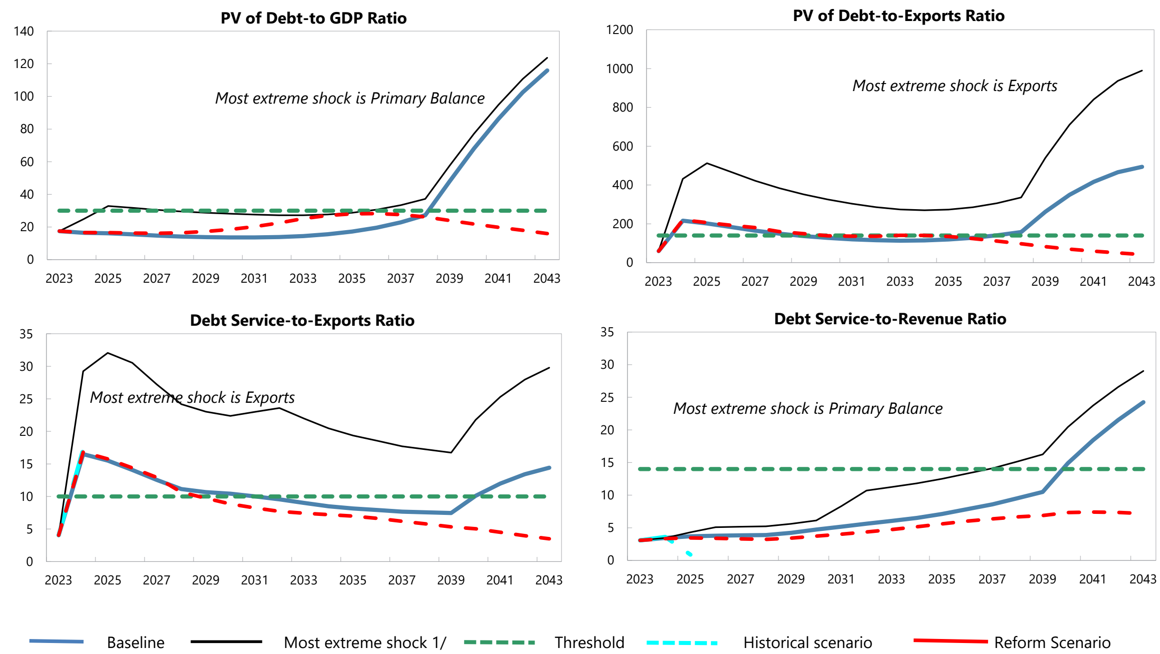
Sources: Country authorities; and staff estimates and projections.

1/ A bold value indicates a breach of the benchmark.

2/ Variables include real GDP growth, GDP deflator and primary deficit in percent of GDP.

3/ Includes official and private transfers and FDI.

Figure 1. Timor-Leste: Indicators of Public and Publicly Guaranteed External Debt under Alternative Scenarios, 2023-2043



Customization of Default Settings		
	Size	Interactions
Tailored Tests		
Combined CLs	Yes	
Natural Disasters	Yes	Yes
Commodity Prices [2/]	No	No
Market Financing	n.a.	n.a.

Note: "Yes" indicates any change to the size or interactions of the default settings for the stress tests. "n.a." indicates that the stress test does not apply.

Borrowing Assumptions for Stress Tests*		
	Default	User defined
Shares of marginal debt		
External PPG MLT debt	100%	
Terms of marginal debt		
Avg. nominal interest rate on new borrowing in USD	1.7%	1.7%
USD Discount rate	5.0%	5.0%
Avg. maturity (incl. grace period)	28	28
Avg. grace period	6	6

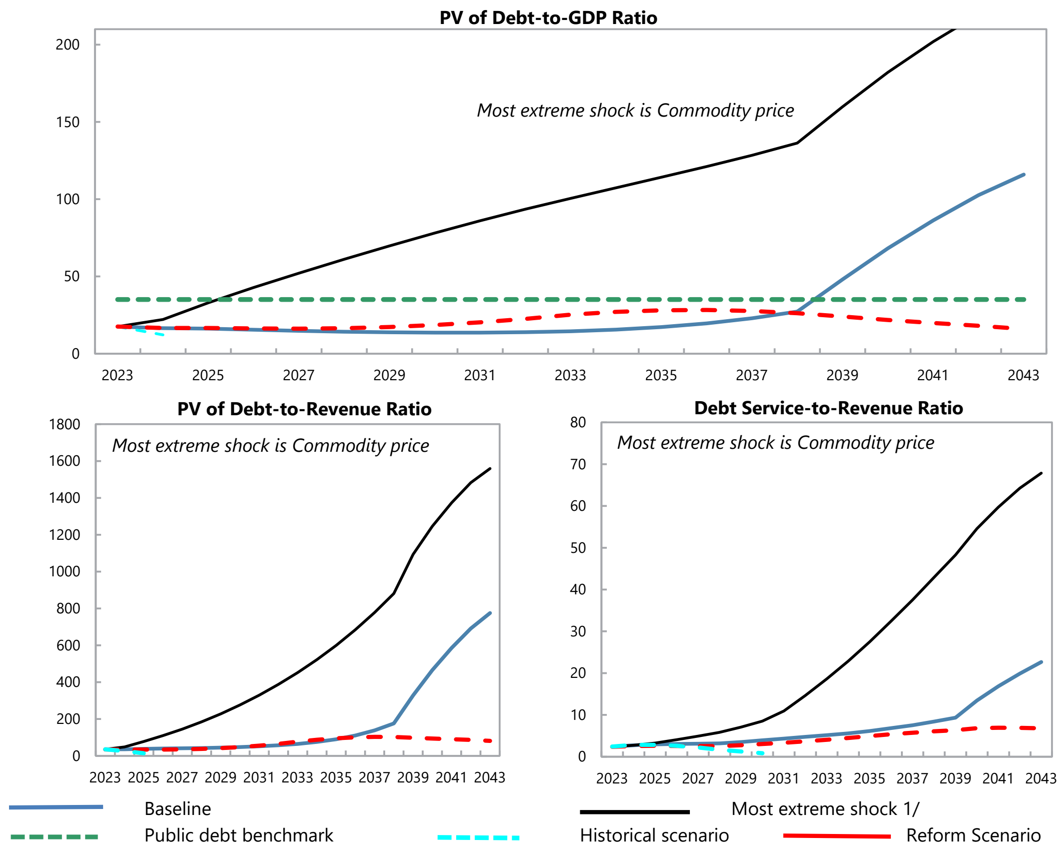
* Note: All the additional financing needs generated by the shocks under the stress tests are assumed to be covered by PPG external MLT debt in the external DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2033. Stress tests with one-off breaches are also presented (if any), while these one-off breaches are deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most exterme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

2/ The magnitude of shocks used for the commodity price shock stress test are based on the commodity prices outlook prepared by the IMF research department.

Figure 2. Timor-Leste: Indicators of Public Debt under Alternative Scenarios, 2023-2043



Borrowing Assumptions for Stress Tests*	Default	User defined
Shares of marginal debt		
External PPG medium and long-term	100%	100%
Domestic medium and long-term	0%	0%
Domestic short-term	0%	0%
Terms of marginal debt		
External MLT debt		
Avg. nominal interest rate on new borrowing in USD	1.7%	1.7%
Avg. maturity (incl. grace period)	28	28
Avg. grace period	6	6
Domestic MLT debt		
Avg. real interest rate on new borrowing	0.0%	0.0%
Avg. maturity (incl. grace period)	1	1
Avg. grace period	0	0
Domestic short-term debt		
Avg. real interest rate	0%	0.0%

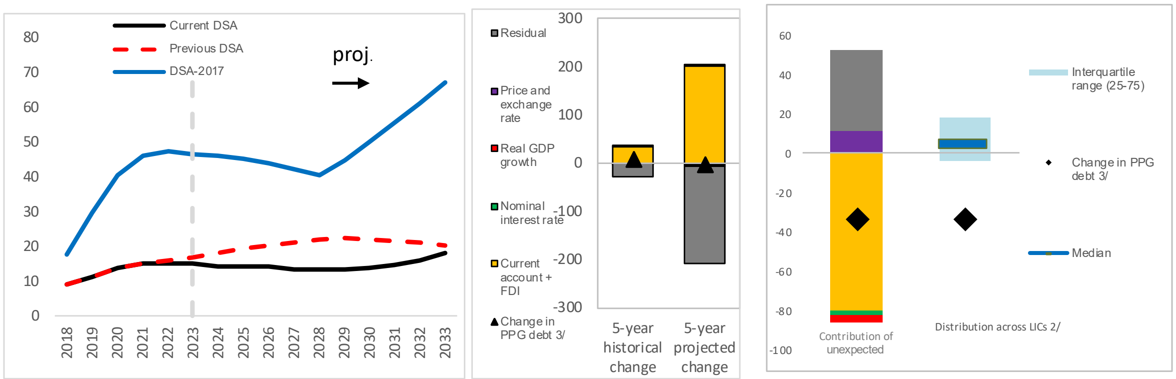
* Note: The public DSA allows for domestic financing to cover the additional financing needs generated by the shocks under the stress tests in the public DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2033. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most exterme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

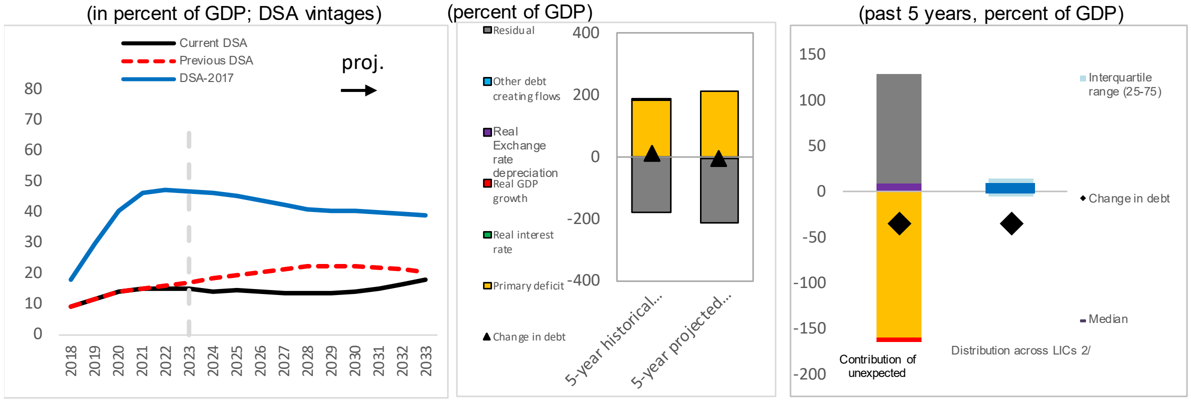
Figure 3. Timor-Leste: Drivers of Debt Dynamics – Baseline Scenario

Gross Nominal PPG External Debt (in percent of GDP; DSA vintages) | Debt-creating flows (percent of GDP) | Unexpected Changes in Debt 1/ (past 5 years, percent of GDP)



Public debt

Gross Nominal Public Debt (in percent of GDP; DSA vintages) | Debt-creating flows (percent of GDP) | Unexpected Changes in Debt 1/ (past 5 years, percent of GDP)



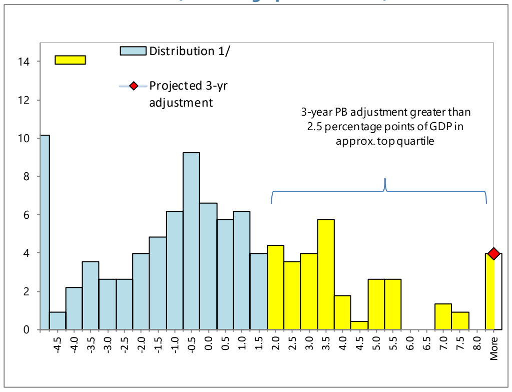
1/ Difference between anticipated and actual contributions on debt ratios.

2/ Distribution across LICs for which LIC DSAs were produced.

3/ Given the relatively low private external debt for average low-income countries, a ppt change in PPG external debt should be largely explained by the drivers of the external debt dynamics equation.

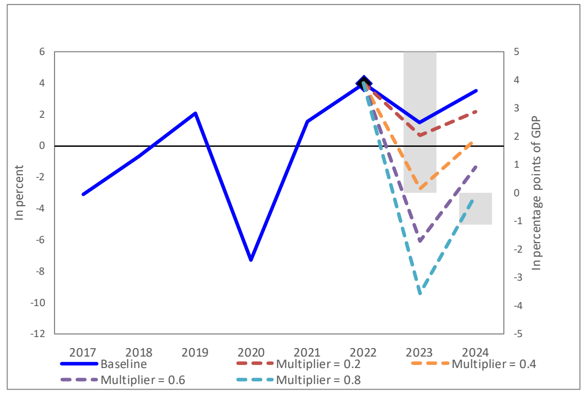
Figure 4. Timor-Leste: Realism Tools

3-Year Adjustment in Primary Balance
(Percentage points of GDP)



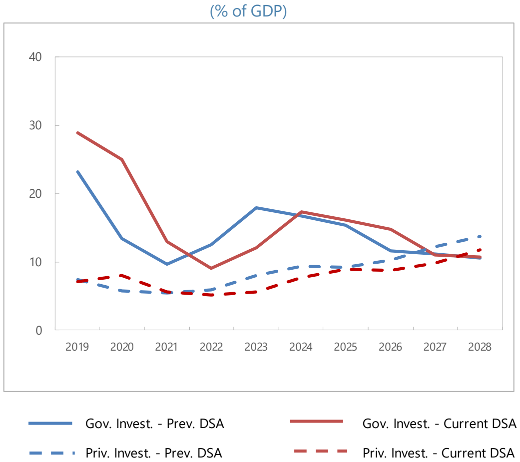
1/ Data cover Fund-supported programs for LICs (excluding emergency financing) approved since 1990. The size of 3-year adjustment from program inception is found on the horizontal axis; the percent of sample is found on the vertical axis.

Fiscal Adjustment and Possible Growth Paths 1/



1/ Bars refer to annual projected fiscal adjustment (right-hand side scale) and lines show possible real GDP growth paths under different fiscal multipliers (left-hand side scale).

Public and Private Investment Rates
(% of GDP)



Contribution to Real GDP Growth
(percent, 5 year average)

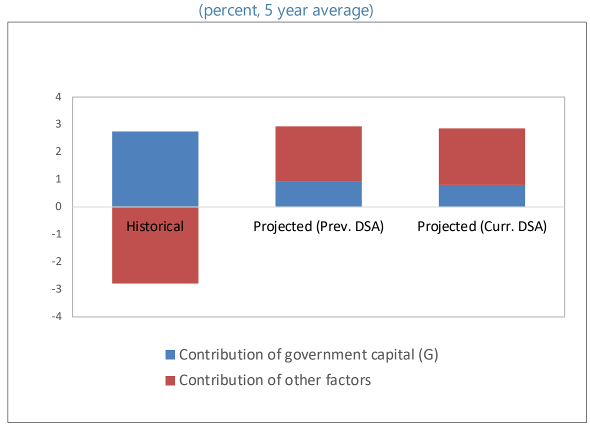
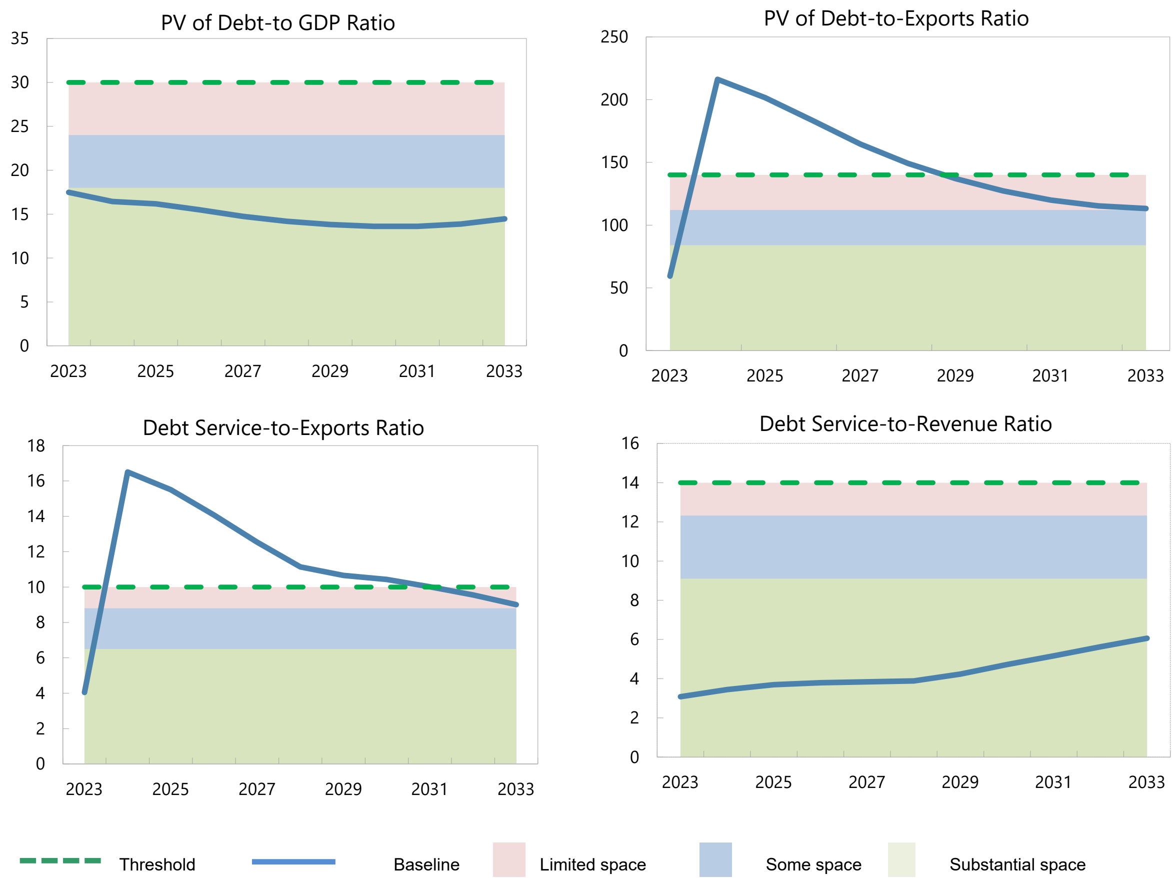


Figure 5. Timor-Leste: Qualifications of the Moderate Category, 2023-2033 1/



Sources: Country authorities; and staff estimates and projections.

1/ For the PV debt/GDP and PV debt/exports thresholds, x is 20 percent and y is 40 percent. For debt service/Exports and debt service/revenue thresholds, x is 12 percent and y is 35 percent.

Statement by Afonso Bevilaqua, Executive Director for the Democratic Republic of Timor-Leste, Bruno Saraiva, Alternate Executive Director, and Pedro Miranda, Senior Advisor
February 21, 2024

On behalf of our Timorese authorities, we thank Mr. Carrière-Swallow and his team for their productive engagement. Timor-Leste is a fragile and post-conflict state, which has been building its institutions from scratch over the past two decades. While many important milestones have been reached in this trajectory, the job is far from finished. International cooperation plays a critical role in supporting the unrelenting homegrown effort. In particular, the authorities attach great importance to IMF surveillance and appreciate the candid dialogue with and policy advice from Fund staff.

Recent economic developments and outlook

Growth will accelerate in 2024 mainly due to increased public investment. Upon taking office, the new administration prioritized public investment in the 2024 budget. The political transition had impacted public investment in 2023, negatively affecting the growth performance. Even so, the authorities' 2023 growth estimate is higher than staff's at 2.2 percent, based on: (i) better than previously assessed budget execution, (ii) increased tourism receipts with spillover effects on consumption and private sector growth—tourist visa issuance surged 129 percent in the first half of the year, and (iii) increased remittances, which were 25 percent higher in the first three quarters of the year and should also drive consumption growth higher. Improved expenditure composition and better budget execution should bolster growth to 4.1 percent in 2024, higher than the 3.5 percent projected by staff. The authorities expect that donor-financed projects will provide an additional boost to growth this year, with current information suggesting that aid disbursements will more than double in 2024, to around $180 million, potentially returning to the level of 2022, after plunging in 2023 due to the political transition. Finally, tourism and remittances, based on current information, will continue to drive growth higher in 2024.

Improved execution will help strengthen the budget's credibility, transparency, and role in planning. The projected deficit (before excess withdrawals and other financing sources) for 2024 is lower than what was projected in the original 2023 budget. In addition, the quality of the budget has significantly improved in 2024, with capital expenditure increasing—especially development capital, which expanded by 54 percent with respect to the rectified budget—while the allocation for transfers has been reduced relative to the 2023 original budget. Moreover, the Fiscal Risk Statement became more informative with the inclusion of data on cash balances for public enterprises. Finally, the expenses related to the accession to ASEAN and the WTO, which will put additional pressure in the budget this year, should be lessened next year.

While high inflation has been more persistent than in peers, it is expected to decline significantly in 2024. Since its establishment as an independent republic, Timor-Leste has adopted the US dollar as its currency, a framework that has worked well as an anchor. Given the high import-content of the price-index basket, the passthrough from international food and fuel prices is on the upper end of the distribution among peers. With the expected accommodation of international prices this year, inflation should converge more quickly than observed so far.

The financial sector remains sound, with low delinquency rates, but financial inclusion and intermediation must increase. Credit growth picked up steam last year; however, loans as a share of deposits remain below 40 percent, while overseas placements represent 60 percent of bank assets. The authorities want to stimulate domestic financial intermediation, without eroding the soundness of financial institutions operating in Timor-Leste. To this end, the BCTL is seeking to foster the sustainable allocation of Timorese savings in the domestic economy. At the same time, greater financial inclusion, by expanding access to bank accounts and credit, would boost financial intermediation and private sector development.

Short-term risks may be tilted to the downside, but upside risks are also significant going forward. As a small, open economy, Timor-Leste is vulnerable to exogenous shocks, including natural disasters. A reversal of the current path for a soft landing in the global economy could affect the returns on the Petroleum Fund. Adverse developments in partners could reduce the inflow of concessional resources affecting the implementation of important investment projects. Higher commodity prices would also pose challenges, affecting both inflation and the current account. On the other hand, an improved execution of capital spending, including by better coordination with development partners, could boost growth this year and going forward. Greater political consensus could improve the prospects for and pace of reforms, increasing overall confidence and attractiveness for investors. Finally, a well-designed approach to the exploration of the Greater Sunrise and other potential fields could have an immediate positive impact on sentiment and investment.

Medium-term challenges and moving out of fragility

The authorities are determined to tackle Timor-Leste's most crucial risk over the medium term, which is the possibility of a fiscal cliff caused by the depletion of the Petroleum Fund (PF). This would force the economy into an abrupt and ruinous adjustment. Avoiding the fiscal cliff requires the efficient utilization of the savings accumulated in the PF to foster economic diversification, develop the private sector, and boost potential growth, while maintaining the social cohesion to undertake the needed reforms. The immediate focus of the administration is on improving the credibility of the budget and the quality of spending, building on the progress made on public financial management (PFM) with the support of IMF capacity development (CD). Continuing to improve public procurement will remain a priority.

Consolidation towards a sustainable level of spending will proceed gradually. The authorities understand the need to follow this path but underscore the many simultaneous constraints that they need to tackle. Social needs are elevated and put significant pressure on political institutions, which have to reconcile different demands and perspectives in the context of a vibrant, nascent democracy. Fiscal balance will be achieved over time in tandem with reforms to improve the business environment and diversify the economy, expanding the role of the private sector. The authorities are committed to build the necessary consensus to move toward a fiscally responsible approach to economic and social development, ensuring that accumulated savings can be used efficiently, without depleting the PF. The authorities count on the support of the Fund and other partners to develop a robust Fiscal Responsibility Law and a Medium-Term Fiscal Framework.

Domestic resource mobilization depends on strong private sector economic activity. The authorities are committed to implementing the VAT to boost revenue mobilization and have developed draft proposals for a new Tax and Duties Act to improve revenue collection. However, domestic revenue mobilization can only sustain the development needs of the country with a robust non-oil economy. Diversification is frequently a non-trivial task for a small economy, not integrated in global value chains. For it to happen, a few priority reforms need to be properly implemented almost simultaneously, while others can be sequenced to build upon the previous successes. In any case, given the circumstances and timing of future deeper integration of Timor-Leste in the regional and global economies, the country should pursue a niche strategy, in order to develop a competitive edge in specific economic activities.

The authorities agree with staff that agriculture and tourism are two sectors that could lead the diversification of the economy. Boosting agriculture, for example, will require stepping up from low-productivity and subsistence models to crops that could replace imports, as well as providing niche products to the international market, such as gourmet coffee. Some binding constraints need to be addressed for agriculture to develop, including access to credit and clarity on land ownership, as well as improved transport infrastructure so that produce can reach consumers with low losses. Investment in infrastructure and human capital is also critical to develop tourism, building on rich attractions related to adventure, history, culture, nature, and biodiversity.

The authorities are committed to creating the conditions to sustainably increase credit supply. The loan-to-deposit requirement was set to challenge private banks to intermediate deposits into the domestic market, instead of simply relying on interest differentials on safe assets abroad. However, the authorities understand that legal reforms need to be addressed, including resolving impediments to securing collateral for loans and furthering common accounting standards for corporate financial statements, tasks that involve a degree of complexity and require the support of development partners. Additionally, taking advantage of digitalization to promote financial deepening and inclusion and improve payment systems will broaden the domestic market and raise productivity in informal sectors. The completion of the submarine cable this year will provide an impulse to this effort by improving internet connectivity.

Fund engagement with Timor-Leste

The Timorese authorities welcome the Country Engagement Strategy and appreciate the support the Fund has provided through a broad CD agenda. The effort to identify drivers of fragility and focus on three major economic challenges is helpful and could foster an important dialogue between different stakeholders in the country. Given capacity and financial constraints, a development strategy to move out of fragility must clearly identify priorities, determine what needs to be done simultaneously to yield the expected results, and set a sensible and consistent sequencing to allow the different tasks to be performed without violating the constraints. The authorities remain willing to work with the Fund and other partners and underscore the importance of coordination (among partners and the administration, and within the government) to enhance synergies and avoid duplication and conflicting initiatives. Fund CD has been highly valuable, and the authorities appreciate the major and effective role played by the Pacific Financial Technical Assistance Centre (PFTAC). However, for Timor-Leste, the distance to Fiji may be an impediment for an even closer relationship, and we reiterate our call to strengthen the involvement of the Capacity Development Office in Thailand (CDOT) in CD delivery to Timor-Leste. Finally, we would like to restate our appreciation for the engagement of the country team and the close attention devoted by Mr. Srinivasan and APD leadership to Timor-Leste, while looking forward to continued Fund's contribution to the authorities' efforts to decisively move the country away from fragility.